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Supreme Court of the United States

OCTOBER TERM, 1973

No. 73-819

EUGENE W. LANDY, *et al.*,

Petitioners,

—v.—

FEDERAL DEPOSIT INSURANCE CORPORATION, Receiver for the Eatontown National Bank, *et al.*,

Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

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FEDERAL DEPOSIT INSURANCE CORPORATION, Receiver for the Eatontown National Bank, *et al.*,

Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

Petitioners pray that a writ of certiorari be issued to review the judgment of the United States Court of Appeals for the Third Circuit entered in this case on July 30, 1973. Petitioners' motion for rehearing and rehearing en banc was denied by order dated August 24, 1973.

Opinions Below

The opinion of the Court of Appeals for the Third Circuit, —— F.2d —— (1973), is annexed and appears at pages 25a-84a of the Appendix hereto.[1] The unreported opinion of the District Court for the District of New Jersey, *Landy et al.* v. *Federal Deposit Insurance Corp., et al.*, Civil Action No. 1561-70 (D. N.J., Sept. 9, 1971), is annexed hereto and appears at App. 1a-20a.

[1] Citations to the Appendix hereinafter will appear "App. ....."

Jurisdiction

The judgment of the Court of Appeals sought to be reviewed was entered on July 30, 1973. The petition for rehearing and rehearing en banc was denied by order dated August 24, 1973 (App. 88a-89a). The jurisdiction of this Court is invoked under 28 U.S.C. §1254(1).

Questions Presented

1. Are respondent stock brokers, as co-conspirators with a bank president in a fraudulent scheme involving the secret trading of securities with bank funds, concealment of which required dissemination of false and misleading financial statements, liable under Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, for the losses suffered by purchasers of bank stock in reliance upon such false and misleading financial statements?

2. Does the holding of the Court below, that respondent brokers were not liable for the losses of stock purchasers caused by the acts of the bank president in furtherance of the conspiracy, conflict with the decision of the Court of Appeals for the First Circuit in *Ferguson* v. *Omnimedia, Inc.*, 469 F.2d 194 (1972), which held that a conspirator is liable under Section 10(b) and Rule 10b-5 for the acts of his co-conspirator even though he did not participate in such acts?

3. Did the Court below—having bifurcated a single conspiracy to engage in securities fraud into two separate securities frauds, one against the bank, and one against the purchasers of bank stock—erroneously affirm dismissal of the action of purchasers of bank stock against respondent

brokers, in conflict with the decisions of other Courts of Appeals and this Court in actions involving conspiracies to violate federal statutes?

4. Even if the Court below were correct in the bifurcation of the conspiracy to defraud, should the strict purchaser-seller limitation of *Birnbaum* v. *Newport Steel Corp.*, 193 F.2d 461 (2d Cir.), *cert. denied* 343 U.S. 956 (1952), be abolished to provide that violators of Section 10(b) and Rule 10b-5 shall be liable for the foreseeable consequences of their fraudulent activities?

5. Does the ruling of the Court below, that petitioners, as shareholders and stock purchasers, have not stated a cause of action against respondent brokers under Section 10(b) and Rule 10b-5 thereunder, raise important questions of law which have produced conflict, disparity and confusion in decisions of Courts of Appeals and which have not been, but should be, resolved by this Court?

Statute and Regulation Involved

This is an action for damages based on violations of Section 10(b) of the Securities Exchange Act of 1934 (hereinafter "the Exchange Act"), 15 U.S.C. §78j(b) (1970), together with Rule 10b-5 promulgated thereunder, 17 C.F.R. §240.10b-5 (1970).

Section 10(b) of the Exchange Act states:

> Section 10. It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—
>
> • • • • •

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Rule 10b-5 provides:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange

(1) To employ any device, scheme or artifice to defraud,

(2) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.

Statement of the Case

1. *Basis for Federal Jurisdiction.*

Federal jurisdiction in the court of first instance is based on Section 27(a) of the Exchange Act, 15 U.S.C. 78aa. Section 27(a) states in pertinent part:

> "The district courts of the United States . . . shall have exclusive jurisdiction of violations of this chapter or the rules and regulations thereunder, and of all suits in equity and actions at law brought to enforce any liability or duty created by this chapter or the rules and regulations thereunder."

2. *The Allegations of the Complaint.*

Petitioners instituted this action in the United States District Court for the District of New Jersey to recover damages under the anti-fraud provisions of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.

The complaint alleged that during the period January 1, 1967 through August 8, 1970, defendant Douglas J. Schotte ("Schotte"), then President of the Eatontown National Bank ("Eatontown"), and various other defendants, by means of a scheme to defraud, secretly and illegally traded an estimated $200 million to $300 million of securities for the account of Eatontown (App. 93a-95a). To conceal the fraud, Schotte caused Eatontown to publish and publicly disseminate false and misleading financial statements and reports which failed to reveal the approximately $4 million of losses arising from the secret and illegal trading (App. 93a). As a result of these losses, Eatontown was declared insolvent and closed by the United States Comptroller of

the Currency on August 8, 1970, and the Federal Deposit Insurance Corporation ("FDIC") was named receiver of Eatontown (App. 29a).

Petitioners were shareholders of Eatontown and purchasers of its stock. They brought suit on behalf of themselves, all other shareholders, and all other persons who purchased Eatontown stock during the period of January 1, 1967 through August 8, 1970, in reliance upon the false and misleading statements and reports. Petitioners further sued derivatively on behalf of Eatontown to recover damages caused Eatontown as a result of the fraudulent scheme.

The defendants below in the individual and class action portions of petitioners' complaint were:

(i) Twelve brokerage firms which conspired with Schotte unlawfully to open accounts and execute or clear transactions for the account of Eatontown pursuant to the instructions of Schotte, and sixteen individuals associated with such brokerage firms (hereinafter collectively referred to as "the respondent brokers");

(ii) Edward R. Burt & Co. ("Burt"), a firm of public accountants retained as auditors of Eatontown; and

(iii) Schotte.[2]

Petitioners were the victims of a fraudulent conspiracy involving what the Court below characterized as "[a]n incredible misuse of funds in stock market speculation . . ."

[2] The respondent brokers, Burt, the FDIC and Schotte were also sued derivately. The New York Stock Exchange, the National State Bank of Elizabeth, and the Federal Reserve Bank of New York were named as defendants but only in the derivative causes of action.

(App. 28a). The principal actors in, and beneficiaries of, that conspiracy were the president of Eatontown, Schotte, and the respondent brokers.[3]

The complaint alleges that during the period January 1, 1967 to August 8, 1970, Schotte opened brokerage accounts with the respondent brokers in the name of "Eatontown National Bank, Attention: Mr. Douglas J. Schotte", and traded through such accounts an estimated $200 million to $300 million of securities (App. 94a). The accounts were opened and the transactions were executed without the knowledge, authority or concurrence of Eatontown's directors (App. 29a). The secret trading was not uncovered until August 8, 1970, when Eatontown was declared insolvent and the FDIC was appointed receiver (App. 29a).

As the district court noted:

> When the end finally arrived, it was estimated that the loss to the Bank was somewhere near $4,000,000 and the Bank's shareholders' loss is alleged to be in excess of $4,000,000 (App. 2a).

The complaint alleges that the secret trading through the respondent brokers constituted a single, unified plan, scheme and device to defraud Eatontown, purchasers of Eatontown's common stock and all of Eatontown's shareholders in violation of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder (App. 93a-94a). The complaint further alleges that, as part of this unified fraudulent conspiracy,

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[3] The Court below noted in its opinion that "[t]he criminal convictions of several of the key malefactors have already been affirmed by this court. *United States* v. *Schotte*, No. 72-1834 (3d Cir. Dec. 15, 1972); *United States* v. *Certilman*, No. 72-2128 (3d Cir. April 24, 1973)" (App. 28a, fn. 1). Certilman is one of the respondent brokers.

Schotte made statements to the named petitioners and sent reports and other communications to all the shareholders of Eatontown which were false and misleading in that they failed to disclose the liabilities of Eatontown arising from the fraudulent conspiracy (App. 93a). Petitioners and the other members of the class represented by them purchased Eatontown's common stock in reliance on such false and misleading statements, reports and other communications (App. 93a).

The district court characterized the fraudulent conspiracy as "remarkably simple in theory, although the technical aspects of execution were quite complex" (App. 2a). At the request of Schotte, the respondent brokers illegally opened and maintained accounts in the name of Eatontown, allegedly for the accounts of undisclosed bank customers. In fact, however, Schotte used the accounts for his personal trading in corporate securities (App. 2a). As the Court below noted:

> Without any authorization, he [Schotte] traded in the name of the bank and covered his losses with cashier's checks issued without consideration to the bank. Apparently, Schotte delayed payment for the purchased securities until the brokers pressed him, a delay often considerable because of a mixture of broker backroom office problems and their desire to retain Schotte's burgeoning business. When pressed for payment, Schotte either sold the stock if it had appreciated or issued a cashier's check signed by him as president of [Eatontown] (App. 29a).

The participation of the respondent brokers was essential to the conspiracy to defraud Eatontown, its share-

holders and purchasers of Eatontown common stock. The complaint alleges that the respondent brokers participated in that fraudulent conspiracy by allowing Schotte to open and maintain brokerage accounts for secret trading in the name of Eatontown. Such accounts were in violation of the National Banking Act, 12 U.S.C. §24 (1970), which prohibits a national bank from purchasing or selling securities with recourse to itself (App. 94a). The complaint also alleges that the respondent brokers, in order to retain Schotte's business, permitted Schotte to delay payment for securities purchased—an illegal extension of credit in violation of the margin requirements of Regulation "T" of the Federal Reserve Board, 12 C.F.R. §§220.1-.8 (1972), issued pursuant to Section 7 of the Exchange Act, 15 U.S.C. §78g (1970) (App. 3a).

The complaint alleges that the respondent brokers knew, or should have known, from the illegal opening of the accounts with recourse to Eatontown, from the volume of trading, the illegal extensions of credit, the illegal manner in which the accounts were handled, specific instructions from Schotte that secrecy was to be maintained, and from personal and direct knowledge of the affairs of Eatontown, that the accounts were part of a device and scheme to defraud (App. 94a-95a).

The motive of the respondent brokers for participating in the conspiracy, as the Court below recognized, was to generate enormous commissions from the secret and illegal trading (App. 67a). The respondent brokers in fact received an estimated $3 million in commissions from such illegal trading, not substantially less than the estimated $4 million which petitioners and other purchasers of Eaton-

town stock lost during the relevant period as a result of the fraudulent conspiracy (App. 30a).

3. *The Decision of the District Court.*

The opinion and order of the District Court for the District of New Jersey (App. 1a-20a), dated September 9, 1971, dismissed all counts of the complaint against all the respondent brokers. The district court based its dismissal of the complaint against the respondent brokers on its determination that there were two separate and distinct frauds committed: one by the respondent brokers and Schotte against Eatontown, and one by Schotte against the shareholders. The district court concluded that since the shareholders were not purchasers or sellers of the securities involved in the fraud against Eatontown, they had no standing under Section 10(b) of the Exchange Act or Rule 10b-5 to sue the brokers. In reaching its decision, the district court placed its principal reliance on the opinion of the Court of Appeals for the Second Circuit in *Birnbaum* v. *Newport Steel Corp.*, 193 F.2d 461 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952).

The district court also dismissed as "premature" the derivative actions against all defendants on the ground that petitioners, as shareholders of Eatontown, had no standing to sue on behalf of Eatontown in the absence of a demand on, and refusal by, the FDIC to bring such suit (App. 15a). In a subsequent opinion and order dated December 9, 1971, the district court also granted the motion of defendant Burt for summary judgment with respect to all claims other than the individual claim of petitioner Eugene W. Landy, on the ground that there was no reliance by any other shareholder of Eatontown on the allegedly false and misleading financial statements certified by defendant Burt (App. 74a).

4. *The Decision of the Court of Appeals.*

Upon appeal, the Court of Appeals for the Third Circuit in an opinion filed July 30, 1973, affirmed all of the orders of the district court except that part of the order of September 9, 1971, dismissing the derivative counts against defendants not named as defendants in a suit subsequently brought by the FDIC as receiver (App. 80a).[4]

Petitioners do not seek certiorari insofar as the Court below affirmed the dismissal of the derivative causes of action or the grant of summary judgment in favor of defendant Edward R. Burt & Co. Petitioners do seek certiorari with respect to that portion of the judgment of the Court below which affirmed the dismissal of petitioners' individual and class actions against respondent brokers under Section 10(b) and Rule 10b-5.

The Court below affirmed the district court's action even though it recognized that petitioners, as purchasers of Eatontown stock, "have alleged a classic 10b-5 violation in their charge that Schotte caused the corporation to issue materially false statements upon which the [petitioners and other purchasers of Eatontown stock] relied in making their purchases" (App. 66a). The Court below also recognized that Schotte caused Eatontown to issue those materially false statements for the sole and deliberate purpose

[4] On February 8, 1972, almost five months after the district court's order, the FDIC, as receiver, initiated a suit on behalf of Eatontown against respondent brokers and Burt. The FDIC's suit had failed to name the Elizabeth Bank, the Reserve Bank, Schotte, the NYSE, and some of respondent brokers as parties (App. 42a). The Court of Appeals remanded to the district court for consideration of the derivative actions as to the parties not named by the FDIC.

of concealing the massive stock fraud that was being perpetrated by Schotte and the respondent brokers on Eatontown and its shareholders (App. 29a).

Moreover, the Court below accepted, for purposes of the motion to dismiss, the allegations of the complaint that the respondent brokers knowingly and actively participated with Schotte "in acts, and practices and courses of business which operated as a fraud or deceit upon the Eatontown National Bank and its shareholders" (App. 93a-94a) and that as "part of a scheme to defraud" (*Id.*), the respondent brokers unlawfully allowed Schotte to open accounts in the name of Eatontown in violation of the National Banking Act, the margin requirements of Regulation "T" issued pursuant to Section 7 of the Exchange Act, and the rules and regulations of the New York Stock Exchange (App. 94a). Finally, the Court below accepted, for purposes of the motion to dismiss, petitioners' allegation that the respondent brokers had actual knowledge that Schotte was causing Eatontown to issue materially false financial statements to its shareholders and purchasers of Eatontown stock solely for the purpose of concealing the fraudulent scheme in which both Schotte and the respondent brokers were jointly engaged (App. 66a).

Nevertheless, the Court below affirmed the district court's dismissal of the complaint against the respondent brokers on the twin grounds that

(i) petitioners "were neither purchasers nor sellers of the two hundred million dollars in stock traded by Schotte through [Eatontown]," and thus lacked standing to sue the respondent brokers under the doctrine enunciated by the Court of Appeals for the

Second Circuit in *Birnbaum* v. *Newport Steel Corp., supra* (App. 52a); and

(ii) with respect to Schotte's fraudulent act in causing Eatontown to issue false financial statements to conceal the two hundred million dollar fraud, "there is [in]sufficient allegation of assistance by the brokers to Schotte in his misleading the shareholders (App. 66a).

In short, the Court below fully insulated the respondent brokers from any liability to petitioners and other purchasers of Eatontown stock, despite the Court's recognition that the fraudulent acts of the respondent brokers were a *sine qua non* of petitioners' loss, despite petitioners' allegation that Schotte and the respondent brokers were engaged in a unified conspiracy to defraud Eatontown and its shareholders, and despite the Court's acceptance of petitioners' allegation that the sole purpose of "misleading the shareholders" (*Id.*) was to cover up the massive stock fraud in which Schotte and the respondent brokers were jointly engaged, for their mutual benefit (App. 29a).

The Court below reached this result by fully accepting the district court's bifurcation of petitioners' allegations into two distinct and independent fraudulent schemes. The district court had characterized the complaint as alleging "*two separate fraudulent schemes*—one '. . . in connection with the purchase and sale of approximately $200,000,000 in securities on the New York and American Stock Exchanges in the name of Eatontown National Bank . . .' and the other '. . . in connection with the purchase of shares of the Eatontown National Bank by the plaintiff shareholders'" (App. 7a, emphasis added). Thereafter in its

decision, the district court separately analyzed each of these supposed "two separate fraudulent schemes" under the headings "Alleged Fraud #1" (App. 7a) and "Alleged Fraud #2" (App. 9a). Such separation, however, did not appear in any of the allegations of petitioners' complaint.

5. *The Effect of the Decisions Below.*

The decision of the Court below deprives purchasers of Eatontown stock of their causes of action under Section 10(b) and Rule 10b-5 to recover losses caused by the knowing participation of the respondent brokers in a fraudulent securities scheme. Those losses cannot be recovered by the derivative action brought by the FDIC as receiver of Eatontown. As the court noted in *Young* v. *Seaboard Corp.*, 360 F. Supp. 490 (D. Utah 1973), in upholding the right of shareholders of an insolvent bank to maintain a Section 10(b) action against defendants who participated in a securities fraud which caused the insolvency of the bank, the shareholders of the bank are "not proper participants in any recovery made by the bank's receiver." (*Id.* at 496).

The court in *Young* pointed out that "the vehicle of a derivative suit is of questionable utility to shareholders of a bankrupt institution" because "[e]ven if the plaintiff shareholders could receive some money recovery as a result of a derivative suit, it would not equal the loss in value of their shares whose value originally included the going concern and good will value of the corporation." (*Id.* at 496-97.) The court added that such loss in the value of plaintiffs' shares "is not comfortably thought of as a loss to the corporation" and "is properly recovered, if at all, by suit in their own behalf." (*Id.*) Petitioners alleged in

their complaint that the fraudulent activities of the respondent brokers resulted in a $4 million loss to Eatontown and an additional $4 million loss to purchasers of Eatontown stock (App. 96a). The loss in the value of petitioners' shares herein, as in *Young*, "is not a loss recoverable by or in behalf of the corporation under rule 10b-5" but rather "properly recovered, if at all, by suit in their own behalf." *Id.*

REASONS FOR GRANTING WRIT

I.

The Court below, in conflict with the First Circuit Court of Appeals, substantially eroded private enforcement of Section 10(b) by failing to apply basic concepts of conspiracy law established by this Court.

A. *The Court Below, in Contrast With the First Circuit Court of Appeals, Improperly Insulated Conspirators From Liability for the Acts of a Co-Conspirator in Furtherance of a Common Fraudulent Scheme.*

Petitioners alleged that Schotte and the respondent brokers were participants in a broad scheme to defraud the Eatontown National Bank and its shareholders, and that the dissemination of false financials was an indispensable act in furtherance of that conspiracy. The Court below accepted petitioners' allegations that the false financials were issued solely to conceal the fraudulent conspiracy and that the respondent brokers knew or should have known that such false financials were being issued for that purpose (App. 29a, 66a). Furthermore, there was absolutely no benefit to be gained directly by Schotte from the issuance of the

false financials because he was not the seller of the Eatontown stock purchased in reliance on those false financials.

Unquestionably, the issuance of the false financials was essential to the success of the conspiracy. It is inconceivable that either Schotte or the respondent brokers could have succeeded in the pursuance of their goals if Schotte had not caused the false financials to be issued, thus deceiving purchasers of Eatontown stock. "Secrecy and concealment are essential features of successful conspiracy". *Blumenthal* v. *United States*, 332 U.S. 539, 558 (1947).

Nevertheless, the Court below insulated the respondent brokers from any liability for the losses caused by Schotte's deception of the purchasers of Eatontown stock. It did so on the ground that it did "not believe there is sufficient allegation of assistance by the brokers to Schotte in his misleading the shareholders" (App. 66a). Although the Court conceded that "the brokers could reasonably foresee" that Schotte would not reveal in the corporation's financial statements the secret trading in securities, (*Id.*) it held that the brokers were not liable for Schotte's act of deception because "they were not involved in any manner with the sale of Eatontown shares or the actual making of any misrepresentations" (App. 67a). "Their assistance", the Court concluded, "although necessary for the accomplishment of Schotte's fraud, was intended to achieve another independent goal—the generation of commissions" (*Id.*).

The ruling of the Court below—that the respondent brokers could not be liable to purchasers of Eatontown stock because they did not actually participate in Schotte's act of deception—sharply conflicts with the decision of the Court of Appeals for the First Circuit in *Ferguson* v.

Omnimedia, Inc., 469 F.2d 194 (1972). The Court there held a conspirator in a scheme to defraud liable for the misrepresentations of a co-conspirator, even though there was no evidence that the conspirator in any way had participated in the deceptive acts upon which the plaintiff relied.

In *Ferguson*, the plaintiff alleged that he had been induced to purchase shares of Omnimedia stock as a result of certain fraudulent misrepresentations, including misstatements made in a balance sheet shown to him by Buckman A. Osborne, an officer and president of the company. Lisabeth Osborne, Buckman's wife and also an officer of the company, was alleged to have been Buckman's co-conspirator, to have participated in the preparation and filing with state authorities of certain "Articles of Amendment" containing false information, and to have acquiesced in the issuance of company shares without lawful consideration.

The district court granted summary judgment for Lisabeth on the ground that "[t]he entire evidence, affidavits as well as deposition testimony, leads to the inescapable conclusion that Mrs. Osborne knew nothing whatsoever about the balance sheet which is the subject of this aspect of the litigation." 469 F.2d at 196. Thus, the district court applied the same direct privity test to Lisabeth's conduct as did the Court below to the respondent brokers' conduct in the instant case.

The First Circuit reversed the district court's judgment. It noted that "it is now well accepted that 10b-5 reaches conspiracies to defraud as well as substantive offenses." 469 F.2d at 197. It then held:

> If Lisabeth took part in a conspiracy, she may be held responsible for the acts of a co-conspirator that actually misled the appellant into buying stock (such as her husband's furnishing of a false balance sheet), *even if she herself did not participate in those acts.* (469 F.2d at 197, emphasis added.)

The First Circuit's opinion in *Ferguson* is in full harmony with the law of conspiracy as illuminated by this Court and as applied in Section 10(b) actions by other Courts of Appeals.[5] It imposes liability upon each conspirator for the fraudulent acts of his co-conspirators, committed in furtherance of the common scheme to defraud, even if the conspirator did not actually participate in the specific act which caused plaintiff's damage.

The Court below, by contrast, held that those who are damaged by the fraud of a conspirator must link his co-conspirators to the *actus* of the fraud by showing that they actively participated in the specific deceitful act which precipitated the injury. The law of conspiracy does not demand so much. But the Court below was led to demand that much because it falsely assumed that, since Eatontown and the purchasers of Eatontown stock were each the victims of isolable fraudulent *acts*, there necessarily must have been two separate and distinct fraudulent *schemes* at work: one by Schotte and the respondent brokers, against Eatontown; the other, by Schotte alone, against petitioners and other purchasers.

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[5] *Cf. Herpich* v. *Wilder*, 430 F.2d 818 (5th Cir. 1970); *Dasho* v. *Susquehanna Corp.*, 380 F.2d 262 (7th Cir. 1967).

B. *The Court Below, by Bifurcating the Alleged Fraudulent Scheme, Committed Precisely the Same Error Condemned by This Court in* Continental Ore Co. v. Union Carbide & Carbon Corp., *370 U.S. 690 (1962).*

The insulation of respondent brokers from liability for the acts of their co-conspirator, Schotte, flowed inevitably from the error of the Court below in affirming the district court's arbitrary and gratuitous bifurcation of a single integrated scheme to defraud into two separate fraudulent schemes. In so bifurcating the conspiracy, the Court below committed precisely the error that this Court specifically condemned in *Continental Ore Co.* v. *Union Carbide & Carbon Corp.*, 370 U.S. 690 (1962).

Petitioners in *Continental* brought a private treble damage action under the anti-trust laws, claiming that respondent had conspired to monopolize trade in ferrovanadium and vanadium oxide. According to the complaint, as a proximate consequence of respondents' monopolistic practices, independent producers of ferrovanadium and vanadium oxide, including Continental, were eliminated from the business. The complaint detailed five separate ventures which Continental had undertaken over a six year period to enter the vanadium business, all of which were allegedly frustrated by respondents' Sherman Act violations.

The Court of Appeals for the Ninth Circuit, in reviewing the rulings of the trial court, examined *seriatim* the several ventures which Continental had undertaken, and ruled separately upon the respondents' alleged damage to Continental in connection with each such venture. This Court held that the Ninth Circuit's technique of *seriatim* examination of the various incidents in an alleged conspiracy constituted error, stating as follows:

> It is apparent . . . that the Court of Appeals approached Continental's claims as if they were five completely separate and unrelated lawsuits. We think this was improper. In cases such as this, plaintiffs should be given the full benefit of their proof without tightly compartmentalizing the various factual components and wiping the slate clean after scrutiny of each. " • • • [T]he character and effect of a conspiracy are not to be judged by dismembering it and viewing its separate parts, but only by looking at it as a whole . . . and in a case like the one before us, the duty of the jury was to look at the whole picture and not merely at the individual figures in it." 370 U.S. at 698-99 (citations omitted).

See also *United States* v. *Patten*, 226 U.S. 525 (1913); *Fontana Aviation, Inc.* v. *Beech Aircraft Corp.*, 432 F.2d 1080 (7th Cir. 1970); *Lessig* v. *Tidewater Oil Co.*, 327 F.2d 459 (9th Cir. 1964).

In the instant case, as in *Continental*, the Court below treated petitioners' allegations of a unified scheme to defraud as if they were allegations of "completely separate and unrelated lawsuits," and after "tightly compartmentalizing the various factual components," wiped the slate clean "after scrutiny of each." If the Court below had taken the broader view which this Court's decision in *Continental* commands, it would have been compelled to conclude that petitioners' allegations made out not two separate frauds, but a series of fraudulent acts inextricably interrelated as essential constituents of a single, unified conspiracy.

The bifurcation of petitioners' allegations into "two separate fraudulent schemes" (App. 7a) was both arbitrary

and gratuitous. The characterizations "Alleged Fraud #1" and "Alleged Fraud #2" are nowhere to be found in petitioners' complaint, nor can they properly be inferred from the allegations set forth therein. Petitioners alleged that Schotte and the respondent brokers jointly engaged in "acts and practices and courses of business" which operated as "*a* fraud" upon Eatontown and its shareholders (App. 93a; emphasis added). Petitioners alleged that the illegal activities of the respondent brokers, including their opening accounts with recourse to Eatontown and their extensions of credit, were all "*part* of *a* scheme to defraud" (App. 94a) (emphasis added). In fact, petitioners specifically alleged that the issuance of the false financials by Schotte was designed to conceal "*the* device and scheme" being practiced by Schotte and the respondent brokers (App. 93a). The complaint is simply barren of any reference, directly or by implication, to "two separate fraudulent schemes," or to any "Alleged Fraud #1" and "Alleged Fraud #2."

The Court below accepted the district court's bifurcation of the conspiracy and affirmed the dismissal of the purchasers' complaint against the brokers merely by observing that "we do not believe there is sufficient allegation of assistance by the brokers to Schotte in his misleading the shareholders" (App. 66a).[6] But "the basic concept of a conspiracy . . . [is that] . . . the act of any one of the conspirators is legally the act of each of them." *Solomon* v.

[6] The improper division of petitioners' allegations into two separate frauds permitted the Court of Appeals to dispose of petitioners' conspiracy argument *sub silentio*. Obviously, for there to be a conspiracy, there must be two or more conspirators. But in consequence of the bifurcation, the Court treated "Alleged Fraud #1" as an event in which Schotte alone participated. It therefore eliminated, by definition, the need for analyzing the fraudulent issuance of false financials in terms of conspiracy law.

United States, 276 F.2d 669, 674 (6th Cir. 1960). Each conspirator is liable for anything done by any of his confederates in furtherance of the common purpose of the conspiracy. *McCandless* v. *Furlaud,* 296 U.S. 140 (1935).

As knowing conspirators in a broad scheme to defraud, each of the respondent brokers is liable for the acts of his confederates committed in furtherance of the common scheme. Because Schotte's violation of Section 10(b) and Rule 10b-5 was such an act in furtherance of the conspiracy, liability must flow through the network of the conspiracy and attach to each of the brokers, even though none of them directly assisted Schotte in the preparation and dissemination of the false financials. It cannot avail the brokers to say that they did not intend to deceive petitioners or to violate Section 10(b) and Rule 10b-5 when they joined in the broader scheme to defraud. For they "must be held to have intended the necessary and direct consequences of their acts, and cannot be heard to say the contrary." *United States* v. *Masonite Corp.,* 316 U.S. 265, 275 (1942), quoting *United States* v. *Patten,* 226 U.S. 525 (1913). And although petitioners did allege that the respondent brokers knew that false financials would be prepared and disseminated by Schotte to cover up the conspiracy—an allegation which the Court below accepted *arguendo* (App. 66a)—it is likewise immaterial whether a co-conspirator approves, or even has knowledge of, any particular act of another co-conspirator if, as here, that act is in furtherance of the conspiracy. *El Ranco, Inc.* v. *First National Bank,* 406 F.2d 1205 (9th Cir. 1968).

By requiring the existence of an affirmative act of misrepresentation on the part of the respondent brokers, or

other affirmative assistance in the issuance of the false financials, as a prerequisite to their liability, the Court below brought itself squarely into conflict with the First Circuit's decision in *Ferguson* v. *Omnimedia, Inc., supra.* The two circuits now stand in sharp conflict as to the nexus required to impose liability upon co-conspirators in a Section 10(b) securities fraud action.

Resolution of that conflict by this Court is necessary to promote consistency in the circuits in cases alleging conspiracy to violate Section 10(b), and to assure that Section 10(b) will continue to be read "flexibly, not technically and restrictively." *Superintendent of Ins.* v. *Bankers Life & Cas. Co.*, 404 U.S. 6, 12 (1971). The decision of the Court below, premised upon a fundamental legal error, is a technical, restrictive reading of Section 10(b), inconsistent with this Court's decision in *Superintendent of Insurance* and in conflict with its command in *Continental.*

II.

The purchaser-seller restriction enunciated in *Birnbaum* v. *Newport Steel Corp.*, 193 F.2d 461 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952) should be abolished.

A. *The* Birnbaum *Requirement Has Resulted in a Patchwork of Contrived Decisions Inequitable to Investors and Inconsistent With the Remedial Purposes of Rule 10b-5.*

The Court below acknowledged that petitioners were defrauded in their capacity as purchasers of Eatontown stock by virtue of Schotte's act in causing Eatontown to issue false financial statements. If, as petitioners have alleged, that act was committed in furtherance of a fraudulent conspiracy in which Schotte and the respondent brokers were knowing participants, then the respondent brokers would be liable, as co-conspirators, to petitioners, as purchasers of Eatontown stock.

The Court below, however, assumed that there were two entirely separate and distinct fraudulent schemes, one against Eatontown, in connection with the secret trading of two hundred million dollars in securities, and one against the purchasers in connection with the issuance of false financial statements. The Court below held that the purchasers lacked standing to sue the respondent brokers in connection with the fraud perpetrated on Eatontown because of the limitation on standing in a Section 10(b) action imposed by *Birnbaum* v. *Newport Steel Corp.*, 193 F.2d 461 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952). *Birnbaum* holds that only purchasers or sellers of securities that are the subject of a fraudulent transaction have standing to sue under Section 10(b). If the Court below was correct in bifurcating the conspiracy, then admittedly

Birnbaum was correctly applied because petitioners "were neither purchasers nor sellers of the two hundred million dollars in stock traded by Schotte through [Eatontown]" (App. 52a).

The *Birnbaum* limitation on standing pertains, whether or not, as here, plaintiffs have in fact been proximately injured as a foreseeable consequence of the fraudulent act complained of, and whether or not, as here, the fraudulent act touched upon plaintiffs' purchase or sale of securities. Indeed, the Court below readily acknowledged that petitioners may well have met the rule articulated by this Court in *Superintendent of Insurance* v. *Bankers Life & Casualty Co., supra,* that Section 10(b) encompasses "injury to an investor caused by deceptive practices 'touching' on the purchase or sale of securities by that investor" (App. 52a).

This Court's ruling in *Superintendent of Insurance* contributed significantly to a clarification of the so-called "first *Birnbaum* requirement," namely, that "[Section 10(b)] was directed solely at that type of misrepresentation or fraudulent practice usually associated with the sale or purchase of securities rather than at fraudulent mismanagement of corporate affairs" (193 F.2d at 464). This Court made clear in *Superintendent of Insurance* that Section 10(b) was not "limited to preserving the integrity of the securities markets," as the Court of Appeals had contended, but that instead

> Section 10(b) must be used flexibly, not technically and restrictively. Since there was a "sale" of a security and since fraud was used "in connection with" it, there is redress under §10(b), whatever might be available as a remedy under state law. 404 U.S. at 12.

This Court, however, has never ruled on the "second *Birnbaum* requirement", namely, that "Rule X-10B-5 extended protections only to the defrauded purchaser or seller" (193 F.2d at 464). Petitioners believe that the time has now come for this Court to do so.

The *Birnbaum* "purchaser-seller" rule has been the subject of extensive appellate litigation—and no end appears in sight. The fundamental reasons for this endless litigation appear to be threefold. First, the "purchaser-seller" rule simply cannot be squared with the plain wording of Rule 10b-5 which makes it unlawful to perform a fraud or deceit upon "any person . . . in connection with the purchase or sale of any security." Second, the "purchaser-seller" limitation produces grossly inequitable results that are antithetical to the broad remedial purposes of the federal securities laws in that investors who are directly and concededly injured by fraudulent practices in securities transactions are nevertheless deprived of the protections of such laws. And third, the lower federal courts have been unable to develop a consistent standard for determining who the proper plaintiffs should be in a Rule 10b-5 securities fraud action and therefore require guidance from this Court.

The instant case is illustrative of the gross inequities inherent in the "purchaser-seller" limitation. Despite the facts that petitioners were purchasers of securities, that they were defrauded in their purchase of securities, that the respondent brokers engaged in fraudulent acts "in connection with" the purchase or sale of securities, and that there was a direct causal connection between the fraudulent acts of the respondent brokers and the injuries suffered by

petitioners in their purchases of securities, petitioners are not even permitted to commence an action against the brokers to test the validity of their allegations. Nothing in the wording of Rule 10b-5 dictates such result, nor are there any principles of fairness at work which dictate that these defrauded petitioners should be denied the protections of the federal securities laws.

Numerous commentators have recognized the inequities inherent in the "purchaser-seller" requirement. It has been variously characterized as an "archaic tool for determining standing," [7] "an unwarranted bias against [non-purchasers and non-sellers]," [8] and inconsistent with the broad spectrum of rights which have mushroomed under the federal securities laws in the last twenty years.[9] The Securities and Exchange Commission has repeatedly advocated abandonment of the "purchaser-seller" limitation as being "too narrow." [10] A growing number of federal courts have attacked the wisdom of the *Birnbaum* doctrine, and some have suggested that the "purchaser-seller" requirement should be abolished outright. *Neuman* v. *Electronic Specialty Co.*, C.C.H. Fed. Sec. L. Rep. ¶92,591 at 98, 704 (N.D. Ill. 1969); *Tully* v. *Mott Supermarkets, Inc.*, 337 F. Supp. 834, 839 (D. N.J. 1972).

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[7] Comment, *The Purchaser-Seller Rule: An Archaic Tool for Determining Standing Under Rule 10b-5*, 56 GEO. L.J. 1177 (1968).

[8] Comment, *The Purchaser-Seller Limitation to SEC Rule 10b-5*, 58 CORNELL L. REV. 684, 699 (1968). *See also*, Lowenfels, *The Demise of the Birnbaum Doctrine: A New Area for Rule 10b-5*, 54 VA. L. REV. 268, 275-76 (1969).

[9] Comment, *Another Demise of the Birnbaum Doctrine: "Tolls the Knell of Parting Day?,"* 25 U. MIAMI L. REV. 131, 143 (1970).

[10] *See A. T. Brod Co.* v. *Perlow*, 375 F.2d 393, 397 n. 3 (2d Cir. 1967); *Vine* v. *Beneficial Finance Co.*, 374 F.2d 627, 633 n. 6, 635 (2d Cir.), *cert. denied*, 389 U.S. 970 (1967).

Rather than face the issue of abolition squarely, however, the lower federal courts have created a patchwork of contrived and inconsistent decisions which bow in the direction of *Birnbaum*, but at the same time recognize that Rule 10b-5 must be given greater remedial scope than *Birnbaum* permits and that a proper 10b-5 plaintiff need not always meet the mechanistic "purchaser-seller" limitation. Thus the Second Circuit, which decided *Birnbaum*, has since held that fraudulently promoted mergers constitute a "forced sale" of the shareholders' stock, and that such shareholders are therefore "forced sellers." *Crane Co.* v. *Westinghouse Air Brake Co.*, 419 F.2d 787, 794 (2d Cir. 1969), *cert. denied*, 400 U.S. 822 (1970); *Vine* v. *Beneficial Finance Co.*, 374 F.2d 627, 635 (2d Cir.), *cert. denied*, 389 U.S. 970 (1967). The same court has also held that a defendant's failure to pay for securities ordered through a broker gives that broker standing under Rule 10b-5 as an "aborted seller." *A. T. Brod & Co.* v. *Perlow*, 375 F.2d 393, 397 (2d Cir. 1967). And both the Tenth Circuit and this Court have held that the exchange of shares in a merger is the equivalent of a "sale" or "purchase" of securities. *SEC* v. *National Securities, Inc.*, 393 U.S. 458, 466-67 (1969); *Knauff* v. *Utah Construction & Mining Co.*, 408 F.2d 958 (10th Cir. 1969).

The most significant, yet inexplicable, inconsistency in the judicial application of *Birnbaum* is the abandonment of the "purchaser-seller" limitation in private actions seeking injunctive relief. In those cases the courts have held that plaintiffs may sue to enjoin fraudulent practices under Rule 10b-5 so long as there is a "causal connection" between the fraudulent practice and plaintiff's loss, whether or not plaintiff was a "purchaser" or "seller" of securities. *Kahan* v. *Rosensteil*, 424 F.2d 161, 170-73 (3d Cir.), *cert. denied*,

398 U.S. 950 (1970); *Mutual Shares Corp.* v. *Genesco, Inc.*, 384 F.2d 540, 546-47 (2d Cir. 1967); *Tully* v. *Mott Supermarkets, Inc.*, 337 F. Supp. 834, 840 (D. N.J. 1972). A leading case comes from the Third Circuit itself. In *Kahan* v. *Rosensteil* the Court said:

> Neither the language of §10b and Rule 10b-5 nor the policy they were designed to effectuate mandate adherence to a strict purchaser-seller requirement so as to preclude suits for relief if a plaintiff can establish a causal connection between the violations alleged and plaintiff's loss . . . . The Act was designed to eliminate deceptive and unfair practices in security trading and to protect the public from inaccurate, incomplete and misleading information . . . . A suit which seeks to enjoin deceptive practices . . . is not inconsistent with this policy and will in fact promote free and open public securities markets (424 F.2d at 173).

To apply the above reasoning to injunctive suits under Rule 10b-5 but not to damage suits is anomalous and unjust. Non-purchasers and non-sellers who are victims of a poorly concealed fraudulent securities scheme can seek injunctive relief. However, non-purchasers and non-sellers who suffer losses as a result of a cleverly concealed securities fraud, and who accordingly did not discover the fraud prior to its consummation, are not permitted to seek redress for their injuries under Rule 10b-5 against the successful perpetrators of the fraud.

This Court has explicitly stated that damage actions under the federal securities laws are an effective companion to injunctive relief in deterring fraudulent securities practices:

> Private enforcement of the proxy rules provides a necessary supplement to Commission action. As in anti-trust treble damage litigation, the possibility of civil damages or injunctive relief serves as a most effective weapon in the enforcement of the proxy requirements. (*J. I. Case Co.* v. *Borak*, 377 U.S. 426, 432 (1964)).

Similarly, lower federal courts have repeatedly recognized that affording private rights of action for damages under Rule 10b-5 not only provides monetary compensation to the victims of fraud but also provides an effective deterrent to fraudulent securities transactions and thus furthers the broad remedial purposes underlying the Rule. *deHaas* v. *Empire Petroleum Co.*, 435 F.2d 1223, 1231 (10th Cir. 1970); *Globus* v. *Law Research Serv., Inc.*, 418 F.2d 1276, 1284-85 (2d Cir. 1969), *cert. denied*, 397 U.S. 913 (1970); *SEC* v. *Texas Gulf Sulphur Co.*, 401 F.2d 833, 854-55 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969); Ruder, *Civil Liability Under Rule 10b-5: Judicial Revision of Legislative Intent*, 57 N.W. U.L. REV. 627, 637 n. 53 (1963). It is generally accepted that where the court does imply a private remedy under a statute "it is acting to further the general purpose which it finds in the legislation . . . ." RESTATEMENT (SECOND) OF TORTS §286, comment d (1965).

B. *The Restrictive "Purchaser-Seller" Limitation Applied by the Court Below Should Be Abandoned in Favor of a Causal Relation Test, Thereby Effectuating the Broad Remedial Intent of Section 10(b) and Rule 10b-5.*

In *J. I. Case Co.* v. *Borak, supra,* this Court considered whether a private cause of action exists for violation of Section 14(a) of the Exchange Act, 15 U.S.C. §78n(a)

(1970). That Section makes illegal the solicitation of any proxy or consent authorization in violation of Commission Rules. In concluding that a private right of action does exist, this Court noted that, although Congress made no specific reference to such a private right of action, one of the chief purposes of Section 14(a) "is the 'protection of investors,' which certainly implies the availability of judicial relief where necessary to achieve that result" (377 U.S. at 432). This Court emphasized that "it is the duty of the courts to be alert to provide such remedies as are necessary to make effective the congressional purpose" (377 U.S. at 433).

The *Birnbaum* rule does not effectuate the congressional purpose in enacting Section 10(b), or the purpose of the Securities and Exchange Commission in promulgating Rule 10b-5 thereunder; on the contrary, it subverts that purpose. It is clear beyond peradventure that Rule 10b-5 makes it unlawful "[t]o engage in any act, practice, or course of business which operates or would operate as a fraud or deceit"—not just upon "purchasers" or "sellers" of securities—but upon "any person."

The Second Circuit reasoned in *Birnbaum* that Rule 10b-5 was promulgated solely for the narrow purpose of closing a "loophole" in Section 17(a) of the Securities Act of 1933 (15 U.S.C. §77q(a)). That Section made illegal the exercise of fraud or deceit on *purchasers* of securities. According to the *Birnbaum* court, Rule 10b-5 merely extended the protections of Section 17(a) to defrauded *sellers* of securities. But Rule 10b-5, as many commentators have correctly noted, does not speak of protections for "sellers" but of protection for "any person." It stands to reason,

as a matter of common sense, if nothing more, that if the Commission had meant "sellers" it would have said "sellers."

Thus the *Birnbaum* court did not merely read Rule 10b-5 technically and restrictively, it simply failed to read the Rule correctly. As a consequence, not only has the purpose of that Rule been subverted, namely, to provide protection to "any person" who is defrauded "in connection with the purchase or sale of any security," but the broader remedial purposes of the entire scheme of the federal securities laws have also been subverted in the process. The courts have recognized that fact where injunctive relief has been sought. Adherence to a different standard in damage actions only immunizes successful fraud perpetrators, who have managed to conceal their frauds until after consummation, from Rule 10b-5 liability.

Accordingly, petitioners urge this Court to abandon the "purchaser-seller" restriction of *Birnbaum* and replace that restriction with the following rule: that "any person" who is injured as a result of fraud "in connection with the purchase or sale of any security" can recover for his injury if he can establish a direct causal connection between the fraudulent act and such injury.

In the recent case of *Young* v. *Seaboard Corporation*, 360 F. Supp. 490 (D. Utah 1973), that is precisely the rule which the District Court adopted in circumstances almost identical to this case. Plaintiffs in *Young* were shareholders of a defunct national bank who alleged that the bank's collapse and resulting worthlessness of their stock were attributable to a fraudulent securities scheme perpetrated by

defendants. Although plaintiffs were neither purchasers nor sellers of any securities involved in the allegedly fraudulent transactions, the court held that they nevertheless had alleged a cause of action under Rule 10b-5. After first carefully analyzing the history and development of *Birnbaum,* the court concluded:

> The judicial struggle with the Birnbaum rule results perhaps from an effort systematically to afford the remedial procedural and substantive advantages of rule 10b-5 to worthy plaintiffs while at the same time avoiding an unsalutary federal absorption and expansion of state corporate law principles. At present the struggle appears to be pruning the three, interrelated limitations of the Birnbaum rule down to one, more modest requirement: Actions under rule 10b-5 must be founded in fraud touching a securities transaction and must exhibit a direct and causal relationship between that fraud and the claimed injury (360 F. Supp. at 494).

The court then applied the "causal relation" test to the facts in issue before it, and stated:

> On the facts pleaded before this court, it is claimed that defendants fraudulently procured uncollectible loans from the bank. Also, it is represented that these fraudulent transactions resulted directly in the collapse of the bank and injury to the plaintiffs because the loss of the loaned money was sufficient without collateral mismanagement to impair the bank's capital . . . . Under the *Bankers Life* standard, the alleged fraudulent granting of the loans and associated mismanage-

> ment are connected with or 'touch' the deposit transactions. . . . There is, therefore, an unbroken causal chain 'linking together' defendants' alleged fraud, plaintiffs' loss and the deposit transactions as well as the loan transcations themselves (*Id.* at 495).

Petitioner's entitlement to the protections of Rule 10b-5 is far stronger than that of the plaintiffs in *Young*. There the fraud practiced on plaintiffs was not separate from that inflicted on the bank. They were defrauded only in their capacity as shareholders of the bank. Petitioners, however, were defrauded not only as shareholders of Eatontown but as purchasers of Eatontown stock. In fact, the fraud complained of occurred in the actual process of their purchase of stock.

C. *The Birnbaum Limitation Is Inconsistent With Generally Applicable Rules of Standing Enunciated by This Court and With Basic Concepts of Tort Law on Which Private Rights of Action for Violation of Rule 10b-5 Are Posited.*

In the instant case, Petitioners have alleged, and the Court below has recognized, that the injuries petitioners suffered as purchasers of Eatontown stock were a result of the fraudulent and secret trading of two hundred million dollars in securities in the name of Eatontown. It is uncontroverted that the respondent brokers were participants in that secret trading. Plaintiffs have also alleged that the respondent brokers knew or should have known that such trading for the account of Eatontown was both illegal and fraudulent.

Outside of the context of Rule 10b-5 actions, this Court has recognized that applicable rules of standing would

permit petitioners to maintain a private right of action for violations of a federal statute. Thus, in *Association of Data Processing Service Organizations, Inc.* v. *Camp*, 397 U.S. 150 (1953), the Court applied two tests to determine whether a trade association had standing to test the validity of certain regulations adopted by the Comptroller of the Currency. Such standing, the court indicated, would be dependent upon, first, whether "the plaintiff alleges that the challenged action has caused him injury in fact, economic or otherwise" (*Id.* at 152); and second, whether "the interest sought to be protected or regulated by the complaint is arguably within the zone of interests to be protected or regulated by the statute . . . in question." (*Id.* at 153.)

Petitioners have clearly *alleged* that the respondent brokers' actions have caused them "injury in fact." The fact that Rule 10b-5, by its terms, protects "any person," also makes clear that the "zone of interests" intended to be protected by the Rule encompasses all investors injured as a result of fraudulent schemes involving the purchase or sale of securities. It is likewise obvious that petitioners, as investors injured by such a fraudulent scheme, are firmly entrenched within that "zone of interests." Accordingly, petitioners have satisfied both of the tests for standing as heretofore articulated by this Court. The failure of the Court below to accord them standing to seek redress against the respondent brokers is nothing less than an unwarranted exception to the principles established by this Court in *Association of Data Processing Service Organizations, Inc.*

The *Birnbaum* "purchaser-seller" limitation is particularly ill-suited for the adequate protection of investors,

given the increasing complexities of present-day securities markets and transactions. As one oft-cited commentator has observed:

> The infinite variety of problems which courts are called upon to consider, the many varieties and complexities of fraud which are possible in contemporary securities markets, the ingenuity of potential wrongdoers—all argue strongly against having any rigid, inflexible judicial requirement other than the presence of the fraud itself as a sine qua non of the right to sue. If such a rigid doctrine is permitted to exist, clearly men will always find ways to perpetrate their wrongdoings without incurring liability. (Lowenfels, n.8 *supra,* at 276.)

Given such complexities, investors may often suffer losses as a result of fraudulent securities transactions, even though their own stock holdings remain unchanged or they do not purchase or sell securities that are the subject matter of the fraud. In such cases, the *Birnbaum* limitation has enmeshed the Courts in "a nagging threshold issue" and has prevented them from coming to grips "with the central problem of most Section 10(b) and Rule 10b-5 cases—whether or not the plaintiff has in fact been defrauded in connection with the purchase or sale of a security." (*Id.* at 277).

The private right of action implied under Section 10(b) of the Exchange Act was born out of the general rule of the law of torts that "disregard of the command of the statute is a wrongful act and a tort" (*Kardon* v. *National Gypsum Company,* 69 F. Supp. 512 (E.D. Pa. 1946), *modified in other respects,* 73 F. Supp. 798 (1947)). The civil

remedies developed for violations of Rule 10b-5 have significantly added to the protection of investors, primarily because that Rule has given the courts the statutory tool to adapt basic concepts of tort law such as scienter, materiality, reliance and causation to the problems of fraud in the intricate merchandise of securities. *See* Comment, "The Purchaser-Seller Limitation to SEC Rule 10b-5," n.8 *supra,* at 699.

Under general tort law courts generally impose liability on tortfeasors for those injuries proximately caused by their wrongful acts. Such liability is limited only when plaintiff's injury could not reasonably have been foreseen as the natural consequence of defendant's action. *See Palsgraf* v. *Long Island R. Co.,* 248 N.Y. 339, 162 N.E. 99 (1928). That principle has no application in cases such as this where the injuries sustained by petitioners and other purchasers of Eatontown stock were both causally related to the respondent brokers' actions and such injuries were clearly foreseeable.

The *Birnbaum* requirement has thus been erected in defiance of basic concepts of tort law on which private rights of action for violation of Rule 10b-5 have been firmly posited. That limitation also precludes the courts from focusing their inquiry in 10b-5 cases on the issue that adheres to any tort action—the causal relationship between the tortious activity and the claimed injuries of the plaintiff. In so doing the *Birnbaum* limitation frustrates effective application of the federal proscriptions against fraudulent securities transactions with respect to "any person."

The purchaser-seller limitation of *Birnbaum* has been engrafted onto Rule 10b-5 by the courts. It has achieved

results inconsistent with the statute, the rule, and Congressional and administrative intent. The inability of the circuit and district courts to treat the critical issue of the standing requirement in 10b-5 cases with any degree of clarity has created a growing disparity among the courts as to precisely what the nature of that requirement is and ought to be. Accordingly, the Supreme Court should take the necessary action to remedy the judicially engendered chaos that characterizes the issue of standing in 10b-5 damage actions.

III.

CONCLUSION

For the foregoing reasons the Petition for Writ of Certiorari should be granted.

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Opinion and Order of the District Court
Dated September 9, 1971

UNITED STATES DISTRICT COURT

FOR THE DISTRICT OF NEW JERSEY

Civil Action No. 1561-70

EUGENE W. LANDY, GLORIA LANDY, HARRY GROSS and FREEHOLD GLASS CO., INC.,

Plaintiffs,

v.

FEDERAL DEPOSIT INSURANCE CORPORATION, *et al.,*

Defendants.

This matter is before the Court on defendants' motion to dismiss the complaint for lack of jurisdiction over the subject matter and for failure to state a claim upon which relief can be granted. *Fed. R. Civ. P.* 12(b) 2, 6.

The complaint itself arises out of the closing in August, 1970, by the Comptroller of the Currency, of the Eatontown National Bank, Eatontown. As appears from the allegations in the complaint the closing was necessitated by the discovery of misappropriations of vast sums of bank funds by the former president and one of the defendants herein, Douglas J. Schotte. During the period from January 1, 1967, to August 8, 1970, the date the bank was closed, Schotte apparently sought to enlarge his own portfolio by trading in corporate securities with member firms of the New York

Stock Exchange. Since his own resources were unable to support the volume of trading he wished to engage in he simply elected to open all his accounts in the name of the Eatontown National Bank. The theory of the scheme was remarkably simple although the technical aspects of execution were quite complex. Schotte envisioned that he could purchase stock in the bank's name allegedly for the account of undisclosed bank customers. Payment for the securities would be delayed until the broker pressed him, which due to the back room office problems or the desire to continue with Schotte's business was often a substantial period of time. When the day of reckoning came Schotte either sold the stock if it had appreciated or he issued a cashier's check which he signed as president of the bank. He apparently had also devised a method of delaying payment on the cashier's checks, a factor which gave him additional time to hold the stock and take advantage of even greater anticipated appreciation. The plan, of course, is based upon a rising securities market, and when the prices slid in late 1969 and early 1970 Schotte found that when he sold his recently purchased shares the selling price was often lower than the purchase price with the result that the bank picked up the difference. As the liabilities of the bank piled up Schotte stepped up his volume of trading in what must have been a desperate attempt to "pick a winner" and thus recoup his losses. When the end finally arrived it was estimated that the loss to the bank was somewhere near $4,000,000 and the bank's shareholders' loss is alleged to be in excess of $4,000,000.

The plaintiffs, all of whom are shareholders of Eatontown, and who acquired stock both before and during Schotte's trading period, allege that this scheme would not have been successful if it were not for the negligence or out-

right aid of the defendants. Specifically, plaintiffs allege that the brokerage houses either knew or should have known that Schotte was not authorized to open any accounts in the bank's name with recourse to the bank. Since a national bank cannot purchase securities for its own account except under closely regulated circumstances it is alleged that all the accounts in question were opened and maintained in violation of the National Banking Act.[1]

It is also alleged that some or all of the broker defendants extended to Schotte special credit terms which were in violation of Regulation T of the Federal Reserve Board[2] which is authorized under the broad grant of authority found in Section 7 of the Securities Exchange Act of 1934.[3]

Lastly, it is alleged that the brokers violated various rules and regulations promulgated by the New York Stock Exchange[4] pursuant to Section 6 of the Securities Exchange Act of 1934.[5] Foremost among these alleged violations is the disregard of Rule 405, the "Know Your Customer Rule" or the "Rule of Due Diligence."

Additional non-broker defendants are named in the complaint because of their alleged negligence or aid in permitting this scheme to operate. Included in this group is the FDIC, acting as receiver of Eatontown, Douglas Schotte, the Federal Reserve Bank of New York, the National State Bank of Elizabeth, accountants Edward R. Burt & Company, and the New York Stock Exchange.

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[1] 12 U.S.C. Sec. 24, Seventh.

[2] 12 C.F.R. Sec. 220.1-220.8 (1970).

[3] 15 U.S.C. 78 g (c).

[4] Rules 405, 410, 415, 416, 417, 418, 419, 420, 421, 425, and 433.

[5] 15 U.S.C. Sec. 78 f.

Plaintiffs allege that jurisdiction is conferred upon this Court by Section 27 of the Securities Exchange Act of 1934[6] and that the various allegations set forth are intended to establish a violation of Section 10(b) of the Securities Exchange Act of 1934[7] and more particularly Rule 10b-5 of the Securities and Exchange Commission[8] promulgated under Section 10 of the 1934 Act.[9]

Plaintiff Eugene W. Landy is a director, vice-president, trust officer and counsel to Eatontown. He is also the principal shareholder. Gloria Landy is his wife. Harry Gross is a shareholder and father-in-law of Eugene Landy. Freehold Glass Company is a shareholder and is alleged to be owned by Harry Gross. All plaintiffs sue as individuals and as representatives of shareholders who fall into different classes depending upon the period of their purchase or sale of Eatontown stock. This opinion is not concerned with any argument as to the potential issues of adequate representation arising under *Fed. R. Civ. P.* 23.

Since the complaint and the amended complaint contain forty-one counts, and since each count refers to different defendants and different types of charges, I shall have to forge through this forest of legalese on a count-by-count basis.

Count 1

Plaintiffs sue the FDIC as successor to Eatontown on behalf of themselves and all shareholders who purchased Eatontown stock between January 1, 1967, and August 7, 1970. It is alleged that Eatontown was caused by Schotte,

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[6] 15 U.S.C. Sec. 78 aa.

[7] 15 U.S.C. Sec. 78 j (b).

[8] 17 C.F.R. Sec. 240.10b-5.

[9] See note 7, supra.

its president, to issue false and misleading financial statements, which the plaintiffs relied upon when they purchased Eatontown stock. As stated this count alleges a violation of Section 10(b) of the Securities and Exchange Act of 1934[10] through Rule 10b-5 of the Securities Exchange Commission.[11] The FDIC charges that the plaintiffs are not representative of the class they claim to sue on behalf of, but that question is not before the Court. The right to bring a private action under Rule 10b-5 has been impliedly sanctioned by the Supreme Court in *J. I. Case Co.* v. *Borak*, 377 U.S. 426 (1964) and more particularly permitted in this

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[10] 15 U.S.C. Sec. 78j: Manipulative and Deceptive Devices. It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

(a) To effect a short sale, or to use or employ any stop-loss order in connection with the purchase or sale, of any security registered on a national securities exchange, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

[11] Rule 10b-5 (17 C.F.R. Sec. 240.10b-5) Employment of Manipulative and Deceptive Devices. It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange.

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

Circuit by *McClure* v. *Borne Chemical Co. Inc.*, 292 F. 2d 824 (3d Cir.), cert. denied, 368 U.S. 939 (1961). The motion by the FDIC to dismiss is denied.

Count 2

Plaintiffs sue Douglas Schotte individually and as a class. No motion has been made with regard to this count.

Count 3

This count is the heart of plaintiffs' case. The allegations set forth here against the brokerage house of TPO, Incorporated, are incorporated in subsequent counts against all other brokers and their firms. Plaintiffs sue individually and on behalf of all shareholders of Eatontown. Paragraph 7 of this count sets forth the theory of plaintiffs' case as a Rule 10b-5 violation.

> "7. On information and belief, the hereinafter-named New York Stock Exchange member firms directly or indirectly, by the use of Instrumentalities of Interstate Commerce and by the use of the mails and by the facilities of the New York Stock Exchange, employed a device, scheme and artifice to defraud the Eatontown National Bank and its shareholders; and engaged in acts and practices and courses of business which operated as a fraud or deceit upon the Eatontown National Bank and its shareholders, said practices being in connection with the purchase and sale of approximately $200,000,000 in securities on the New York and American Stock Exchanges in the name of the Eatontown National Bank, and in connection with the purchase of shares of the Eatontown National Bank by the plaintiff shareholders."

Paragraph 7 alleges that there are two separate bases for finding a 10b-5 violation since there were two separate fraudulent schemes—one ". . . in connection with the purchase and sale of approximately $200,000,000 in securities on the New York and American Stock Exchanges in the name of Eatontown National Bank . . ." and the other ". . . in connection with the purchase of shares of the Eatontown National Bank by the plaintiff shareholders." For the reasons set forth below I find that neither of these alleged fraudulent schemes gives rise in these plaintiffs the right to maintain a private cause of action against the broker defendants for a violation of Rule 10b-5.

> Alleged Fraud #1—"in connection with the purchase and sale of approximately $200,000,000 in securities on the New York and American Stock Exchanges in the name of Eatontown National Bank."

Plaintiffs argue that TPO, Incorporated, and the other brokers knew or should have known that their transactions with Schotte were in violation of the National Banking Act,[12] Regulation T of the Federal Reserve Board,[13] and the Rules and Regulations of the New York Stock Exchange.[14] Assuming, as we must, that these allegations are true, and assuming further that these violations are evidence of a scheme or plan to defraud the Eatontown National Bank the fact remains that the present plaintiffs were neither the purchasers nor sellers in those transactions, and as a result they are not afforded protection under Section 10(b) or Rule 10b-5. *Birnbaum* v. *Newport Steel*

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[12] See note 1, supra.

[13] See notes 2, 3, supra.

[14] See notes 4, 5, supra.

Corp., 193 F. 2d 461 (2d Cir.), cert. denied 343 U.S. 956 (1952). The conclusion reached by Judge Hand in *Birnbaum* that Congress meant Section 10(b) to be "directed solely at that type of misrepresentation usually associated with the sale or purchase of securities" and that Rule 10b-5 "extended protection only to the defrauded purchaser or seller" (193 F. 2d at p. 464) has been approved and reaffirmed by cases and commentators alike. *Iroquois Industries, Inc.* v. *Syracuse China Corp.*, 417 F. 2d 963 (2d Cir. 1969); *Greenstein* v. *Paul*, 400 F. 2d 580 (2d Cir. 1968); 6 Loss, Securities Regulation (Supp. 1969) 3617. In this Circuit the rule has also been recognized although it is not applied in cases involving injunctive relief where no damages are sought. *Kahan* v. *Rosenstiel*, 424 F. 2d 161 (3d Cir. 1970) (consistent with 2d Circuit).

While recognizing the continuing validity of Birnbaum, plaintiffs ask that I either find it is error, or find that since the bank is in receivership the shareholders are really forced sellers.[15] I decline both invitations, the first because I think Birnbaum is the correct statement of the law, and the second because even under the forced sale theory plaintiffs would be sellers of Eatontown stock not the $200,000,000 in securities which make up the crux of the fraud charge. In addition, I do not feel it is the function of the judiciary to place contrived interpretations on legislative acts simply to provide a plaintiff with a forum to air his cause of action, especially when he may have ample jurisdiction in the State courts.

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[15] See, *Vine* v. *Beneficial Finance Co.*, 374 F. 2d 627 (2d Cir. 1967).

> Alleged Fraud #2—"in connection with the purchase of shares of Eatontown National Bank by plaintiff shareholders."

The essential aspect of this fraud is that the brokers participated in a scheme to defraud the bank's shareholders by not revealing to the shareholders the pertinent facts of their involvement with Schotte's scheme. There is a second possible theory and that would be that the brokers were either aiders and abettors or conspirators in which case they would not have to make any representations to the shareholders because they would be held liable for Schotte's affirmative misrepresentations. Both theories are interesting but again I do not find that they establish a cause of action against the brokers for a Rule 10b-5 violation.

The overall problem with these allegations is that they are contrived. Through the use of a series of sand bridges plaintiffs have attempted to turn a misapplication of bank funds into a securities case by showing that the bank collapsed as a result of Schotte's thefts and that if the shareholders had been warned in advance they would have sold, not purchased, Eatontown stock. The crucial factor is that Schotte's scheme was not centered about the rise or fall of Eatontown shares. I have no trouble deciding that if this case were instituted years ago it would have been simply characterized as a case of corporate mismanagement whose incidental effect was a decline in the value of the corporate stock. However, over the years the oft-quoted statement that Rule 10b-5 was not intended to serve as a vehicle to attach federal jurisdiction over corporate mismanagement situations has been whittled down without the benefit of any Supreme Court guidance to the point today that some courts have held that all you need to have jurisdiction at-

tach is some purchase or sale transaction associated with the corporate mismanagement.[16] However, there is recent evidence that a more careful analysis of the complaint should be made in order to determine whether a corporate mismanagement situation or a Rule 10b-5 action exists. See *Drachman* v. *Harvey*, —— F. 2d —— (2d Cir., 1971); *Superintendent of Insurance of the State of New York* v. *Bankers Life and Casualty Co.*, 430 F. 2d 355 (2d Cir., 1970), cert. granted, 401 U.S. 973 (1971). There is at any rate often only a fine line of distinction between corporate mismanagement generally and a type which breeds jurisdiction under Rule 10b-5. The appropriate test would seem to be one of proximity. The Court should examine how closely related the security transaction is to the mismanagement. As the two move closer together the imaginary line between them vanishes and they become indistinguishable, in which case you have a 10b-5 action. In the present case I do not see the actions of the brokers, whether they be legal or illegal in themselves, as sufficiently closely related to the purchase of Eatontown stock to sustain a 10b-5 violation. In arriving at this conclusion I am supported by my findings below that the brokers owed no duty to the shareholders to make disclosures and that there are insufficient connections between Schotte's fraud upon the shareholders and the brokers' alleged knowledge or partic-

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[16] See, *Schoenbaum* v. *Fristbrook*, 405 F. 2d 215 (2d Cir. 1968); *Parker* v. *Baltimore Point & Chemical Corp.*, 244 F. Supp. 267 (D. Colo. 1965); *Kane* v. *Central American Mining & Oil, Inc.*, 235 F. Supp. 559 (S.D.N.Y. 1964); *New Park Mining Co.* v. *Cranmer*, 225 F. Supp. 261 (S.D.N.Y. 1963); *Petit* v. *American Stock Exchange*, 217 F. Supp. 21 (S.D.N.Y. 1963); but see, *SEC* v. *Fifth Avenue Coach Lines, Inc.*, 289 F. Supp. 3 (S.D.N.Y. 1968); *Kamensky* v. *Abrams*, 281 F. Supp. 501 (S.D.N.Y. 1968); *Cohen* v. *Colvin*, 266 F. Supp. 677 (S.D.N.Y. 1967).

ipation in such fraud to merit inclusion under an aiding or abetting or conspiracy theory.

With regard to the duty to disclose which plaintiffs would have this Court impose upon the brokers, I find that plaintiffs have advanced no convincing authority which would lead me to accept this proposition. Reliance upon *SEC* v. *Texas Gulf Sulphur Co.*, 401 F. 2d 833, (2d Cir.), cert. denied sub nom. *Coates* v. *SEC*, 394 U.S. 976 (1969) does not assist plaintiffs' argument since here there is no participation by the brokers in any misrepresentation to any shareholder nor is there any sale by any broker for that matter. Id. at 862. The brokers were not corporate insiders nor were they under any duty to independently contact shareholders of Eatontown. While silence can be actionable under special circumstances, there must first be some independent duty to disclose. See, *Fisher* v. *Keltz*, 266 F. Supp. 180 (S.D.N.Y. 1967); *Connelly* v. *Balkwill*, 174 F. Supp. 49 (N.D. Ohio 1959), aff'd on opinion below, 279 F. 2d 685 (6th Cir. 1960). In a most recent opinion dealing with an alleged duty of disclosure by an accountant the Court states:

> "We find nothing in Rule 10b-5 that purports to impose liability on anyone whose conduct consists solely of inaction. On the contrary, the only subsection that has any reference to an omission, as distinguished from affirmative action, is subsection (2) providing that it is unlawful 'to omit to state a material fact necessary in order to make the statements made • • • not misleading,' i.e., an omission occurring as part of an affirmative statement. (Citation omitted) We perceive no reason, consonant with the Congressional purpose in enacting the Securities and Exchange Act of

> 1934, thus to expand Rule 10b-5 liability. (Citation omitted) On the contrary, the exposure of independent accountants and others to such vistas of liability, limited only by the ingenuity of investors and their counsel, would lead to serious mischief." *Wessell* v. *Buhler,* 437 F. 2d 279, at 283 (9th Cir. 1971).

It is my opinion that in order to create a duty of disclosure where none ordinarily exists plaintiffs will have to fall back on the more traditional factors of scienter, reliance by the investor, and special relationship between the corporation and the defendant. These factors are simply not present here.

In addition to non-disclosure plaintiffs argue that there were affirmative misrepresentations by some of the brokers.[17] However, during depositions, only plaintiff Landy could expand on these allegations and his answers established only that the named brokers never volunteered to him that they were doing business with the bank. He in turn never asked if they were, and neither side made any representations concerning the general nature of these activities.[18] I do not find these conversations to be affirmative misrepresentations. Landy's case on disclosure must be examined on the theory of some duty to disclose, and upon examination I conclude that no such duty was established. The fact that these brokers knew or should have known that Schotte was acting without authority does not require them to disclose such information to the shareholders. This, of course, has nothing to do with their potential liability

[17] See Paragraph 11 of Count 3.

[18] See Transcript of deposition of Henry Gross, Gloria Landy and Eugene Landy (Mar. 15, 1971), pp. 114 et seq.

to the shareholders under a properly pleaded derivative suit where the shareholders seek to recover for their damages caused by the collapse of the bank. In that case the crucial aspect would be whether or not the brokers are responsible for the fall of the bank not whether or not they owed a duty of disclosure to the shareholders.

The aiding and abetting and conspiracy arguments are also ill-fated in that they seek to bring this case in the back door when it is readily apparent that it cannot come in the front door. Reliance here is based upon theories discussed in *Brennan* v. *Midwestern Life Insurance Company*, 259 F. Supp. 673 (N.D. Ind. 1966); but see, *Wessel* v. *Buhler*, supra; *Fisher* v. *Kletz*, 266 F. Supp. 180 (S.D.N.Y. 1967). However, the facts alleged in the present case simply cannot support such a theory. The fraud in which the brokers are alleged to have aided or conspired with Schotte was the fraud concerning the $200,000,000 in security transfers not the fraud against the shareholders. The allegation of a second fraud is a mere conclusory allegation not supported by the facts set forth in the complaint. The brokers were not involved in any transaction with regard to Eatontown shares, they did not make any representations concerning same, no reliance upon any broker activity is alleged, no duty of disclosure was breached, and, finally, there is no allegation that the brokers knew or took part in the preparation or dissemination of any false financial statements which Douglas Schotte is alleged to have engineered.

Counts 4-14

These counts are all individual and class actions against the brokerage houses which did business with Douglas Schotte and Eatontown. They are all dismissed for the reasons stated as to Count 3.

Counts 14-30

Named here are individual brokers who acted on behalf of the brokerage houses named in prior counts. All these counts are dismissed for the reasons stated as to Count 3.

Count 31

Plaintiffs bring this suit derivatively on behalf of Eatontown against all defendants named in Counts 1-30 in order to recover the estimated loss suffered by the bank. Plaintiffs further allege they have standing to bring this action because no demand can be made upon the shareholders or directors of the bank due to the receivership. They further allege that the FDIC as a creditor will be in conflict with its role as receiver in pursuing this claim. I do not agree.

The FDIC is mandated to act as receiver for all insolvent national banks. 12 U.S.C. Sec. 1819, et seq. The Act requires the Comptroller of the Currency to appoint the FDIC as the receiver whenever a national bank closes. 12 U.S.C. Sec. 1821(c). Having taken the place of the bank the FDIC is the only body authorized to sue on behalf of the bank. *Lucking* v. *Delano,* 129 F. 2d 283 (6th Cir. 1942); *Lucking* v. *Delano,* 117 F. 2d 159 (6th Cir. 1941); *Wales* v. *Jacobs,* 104 F. 2d 264 (6th Cir. 1939), cert. denied, 308 U.S. 599 (1939); *Davis Trust Co.* v. *Hardee,* 85 F. 2d 571 (D.C. Cir. 1936).

In order to maintain a derivative action the shareholders must first make demand upon the corporation and if they are refused by the corporation they must set these facts forth with particularity in their complaint. This is a rule of long standing and it applies equally well to the present situation where the FDIC is the receiver. *Lucking* v. *Delano,* 129 F. 2d, at page 285, supra; *Lucking* v. *Delano,*

117 F. 2d, at page 160, supra; *City of Fort Worth* v. *McCamey*, 93 F. 2d 964 (5th Cir.), cert. denied, 304 U.S. 571 (1937); see also, Fed. R. Civ. P. 23.

Plaintiffs allege as their only justification for not making a formal demand upon the FDIC that since there is a built-in conflict of interest such demand is unnecessary. Having examined the relevant statutes I find that to uphold plaintiffs' view would severely restrict the Congressional intent expressed in 12 U.S.C. Sec. 1821(d) (the grant of powers clause). The FDIC is almost always a creditor of a collapsed national bank, a fact which Congress was well aware of when these relevant statutes were enacted. The primary objective of the FDIC is to marshall funds for distribution, a goal which would include protection of the shareholders. 12 U.S.C. Sec. 192; see also, 12 U.S.C. Sec. 197. Furthermore, the exclusiveness of the FDIC's control to protect the interests of creditors and shareholders has been adequately supported by prior court decisions.[19] The further allegation in the briefs that the FDIC would be unable to bring suit against another government agency is equally without merit.[20] In the present case the receiver has stated to the Court that it does in fact intend to bring suit against all parties responsible for the collapse of the bank. Until that representation is either contradicted by specific acts or inaction or until plaintiffs make a demand upon the FDIC they are without standing to pursue the matter independently.

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[19] *District of Columbia* v. *Wardell*, 32 F. Supp. 769 (D.D.C. 1940), rev'd on other grounds, 122 F. 2d 202 (D.C. Cir. 1941); *Grindley* v. *First National Bank of Detroit*, 87 F. 2d 110 (6th Cir. 1936); *Liberty National Bank* v. *McIntosh*, 16 F. 2d 906 (4th Cir. 1927).

[20] See, *In re Anjopa Paper & Board Mfg. Co.*, 269 F. Supp. 241 (S.D.N.Y. 1967).

Count 32

Plaintiffs sue the National State Bank of Elizabeth, the correspondent bank which provided computer services to Eatontown. The defendant bank is alleged to have negligently handled the Eatontown account in such a manner as to aid Schotte in furtherance of his scheme to purchase and sell securities. Plaintiffs bring this action derivatively on behalf of the bank which they allege is involved with a conflict of interest due to the receivership of the FDIC. For the reasons stated above in the analysis of Count 31 I dismiss this count as having been brought prematurely without a proper demand upon the FDIC.

Count 33

The Federal Reserve Bank of New York is named as a defendant for alleged negligence in performing its duties as the clearing bank for Eatontown. This is a derivative suit and I order it dismissed as having been brought prematurely without a proper demand upon the FDIC.

Count 34

Plaintiffs sue Edward R. Burt & Company, an accounting firm which was retained in 1967, through 1970, to prepare and certify Eatontown's financial statements, for negligence or gross negligence in their failure to discover the millions of dollars in liabilities which the bank had accumulated as a result of Schotte's trading. It is further alleged that the financial statements issued by Burt & Company were false and misleading and that the plaintiffs relied upon them in purchasing bank stock. At least, one plaintiff, Landy, alleged in oral argument that as a director he received special reports from Burt & Company certifying the bank's sound financial position only a month before the collapse.

Jurisdiction here is rested upon a violation of Rule 10b-5 of Section 10 of the Securities Exchange Act of 1934, 15 U.S.C. 78j. At this stage of the proceedings I find that Burt & Company was in a special position as auditor for Eatontown, that gross negligence as is alleged here can support a fraud charge when coupled with affirmative representations to the plaintiffs. In this regard the analysis found in *Fisher* v. *Kletz*, supra, is helpful. The case of *Wessel* v. *Buhler*, supra, is not inconsistent with my position since there the accountant was found not to have made any representations to shareholders directly or indirectly. Here the allegation is otherwise. Plaintiffs have alleged that a defendant with special inside information has made affirmative representations to the investing public which they claim were false and misleading; the fact that Burt & Company did not profit from any scheme to manipulate the stock of Eatontown is not dispositive of their potential liability. The questions for trial concern the type of negligence, its communication to the investors, and the likelihood of reliance. This count remains.

Count 35

All the allegations of Count 34 are incorporated here and plaintiffs sue Burt & Company derivately on behalf of the bank which they allege is unable to sue due to the previously discussed conflict of interest of the FDIC. As I have previously stated in other counts, I order this count dismissed as having been prematurely brought without a proper demand upon the FDIC.

Count 36

This claim is brought against all defendant brokerage firms under the theory that this Court has pendent jurisdiction since the claim arises out of the same transaction as the Rule 10b-5 claims. In addition, it is alleged that a violation of Rule 405 of the New York Stock Exchange gives rise to a private cause of action under Section 27 of the Securities Exchange Act, 15 U.S.C. 78aa.

Although numerous cases have held that a violation of rules of a stock exchange do not give rise to liability against the broker[21] there have been recent indications that in situations where fraud is alleged a 405 violation may support a private right of action against the broker.[22] Even in the absence of pendent jurisdiction a strong case could be made for jurisdiction under 28 U.S.C. Sec. 1331(a) 1964, i.e., the federal question jurisdiction. The 405 claim could be incorporated into the federal common law as one arising in conjunction with a scheme of regulation of investor protection. The desirability of a Federal forum might outweigh the State forum here in order to avoid inconsistent treatment of these cases. Further advantages would include a balancing of SEC and investor interests within the same Court structure. In any event, the unfortunate aspect for the plaintiffs of any such theory is that the private right to suit would not extend beyond the purchaser who dealt with the broker. No case has gone beyond that guide and to do

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[21] *Colonial Realty Corp.* v. *Bache & Co.*, 358 F. 2d 178 (2d Cir.), cert. denied 385 U.S. 817 (1966); *O'Neill* v. *Maytag*, 339 F. 2d 764 (2d Cir. 1964); *Mercury Investment Co.* v. *A. G. Edwards & Sons*, 295 F. Supp. 1160 (S.D. Tex. 1969).

[22] *Buttrey* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 410 F. 2d 135 (7th Cir.), cert. denied, 396 U.S. 838 (1966); *Aetna Casualty & Surety Co.* v. *Paine, Webber, Jackson & Curtis*, 1969-1970 CCH Fed. Sec. L. Rep. Sec. 92, 748 (N.D. Ill. 1970).

so would go beyond the theory of protection which the rule, arguably, was designed to cover. This finding, of course, has no application to any possible suit brought by the bank as purchaser or by plaintiffs in a State court action for negligence. The pendent jurisdiction allegation is also without merit since I have previously dismissed those counts which would provide this supplemental support.

Count 37

This is a derivative action on behalf of Eatontown against all defendants named in Count 36. As with other derivative actions this count is dismissed as having been brought prematurely without a proper demand upon the FDIC.

Count 38—Amendment to the Complaint

This is a derivative count seeking damages against the New York Stock Exchange and all broker defendants for alleged violations of the Rules of the New York Stock Exchange. Since this count is dismissed as being prematurely brought without proper demand upon the FDIC, I will not at this time go into the relative merits of the allegations.

Count 39—Amendment to the Complaint

The allegations of Count 3 are repeated as to Singer, Kaplan, Rippel & Burley, Inc., another broker alleged to have dealt with Schotte. For the reasons set forth in the discussion of Count 3, this count is also dismissed.

Count 40—Amendment to the Complaint

This is a derivative action against the same broker sued in Count 39. This count is dismissed as having been brought prematurely without a proper demand upon the FDIC.

Count 41

Plaintiffs sue derivatively all brokers and the New York Stock Exchange on account of alleged extensions of credit which were violative of Regulations T, U, and G issued by the Board of Governors of the Federal Reserve Board. Without determining the relative merits of these allegations the count is dismissed as having been brought prematurely without a proper demand upon the FDIC.

Amendment to Count 24

The substitution of the name of Frank Devlin for John Clevenger is noted but the count is dismissed according to the discussion of the issues in Count 3.

In accordance with the findings and reasoning as stated in this opinion, it is, on this 9th day of September, 1971,

ORDERED, that all counts of this Complaint, except Counts 1, 2, and 34, that is, those seeking judgment against the FDIC, Douglas J. Schotte and Edward R. Burt & Company, respectively, be and hereby are dismissed.

LAWRENCE A. WHIPPLE
U.S.D.J.

Letter Order of District Court Dated October 20, 1971, Denying Plaintiff Landy's Motion For Reargument

October 20, 1971

Re: Landy, et al. v. F.D.I.C., et al.
Civil Action No. 1561-70

Gentlemen:

Plaintiff Landy has filed a motion for reargument pursuant to Rule 12(i) of the local rules of this district. The motion is directed at my finding that the allegations of the complaint do not properly allege a violation of Rule 10b-5 by the stockholders "in connection with the purchase of shares of Eatontown National Bank by plaintiff shareholders." Landy makes reference to the theory of conspiracy and aiding and abetting, both of which he has previously argued.

I have carefully considered the memorandum submitted by counsel but I fail to see any point of law other than those which have been discussed in my prior opinion at pps. 10-16. Specifically, I refer plaintiff to p. 15:

"• • • The allegation of a second fraud is a mere conclusory allegation not supported by the facts set forth in the complaint. The brokers were not involved in any transaction with regard to Eatontown shares, they did not make any representations concerning same, no reliance upon any broker activity is alleged, no duty of disclosure was breached, and, finally, there is no allegation that the brokers knew or took part in the preparation or dissemination of any false financial state-

ments which Douglas Schotte is alleged to have engineered."

For the reasons set forth above and for the other reasons stated in my opinion, plaintiff Landy's motion for reargument is denied without costs. Plaintiff Landy shall submit an appropriate order.

Very truly yours,

LAWRENCE A. WHIPPLE
U.S.D.J.

LAW:pr
cc: Clerk of the Court

Judgment Upon Multiple Claim and Multiple Parties Pursuant to Federal Rule 54(b), And Order Entered Pursuant to 28 U.S.C. 1292(b) Dated December 1, 1971

UNITED STATES DISTRICT COURT

FOR THE DISTRICT OF NEW JERSEY

Civil Action No. 1561-70

EUGENE W. LANDY, *et al.*,

Plaintiffs,

—v.—

FEDERAL DEPOSIT INSURANCE CORPORATION, Receiver for the Eatontown National Bank, *et al.*,

Defendants.

An Opinion having been filed on September 13, 1971, dismissing all counts of the Complaint, except Counts 1, 2 and 34, the Court hereby certifies that there is no just reason for delay and expressly directs the entry of final judgment dismissing Counts 3 through 33, inclusive, and Counts 35 through 41 inclusive, and it is so Adjudged, without costs;

IT IS HEREBY ORDERED, pursuant to 28 U.S.C. 1292, that the interlocutory orders denying dismissal of Count 1 and Count 34 involved controlling questions of law as to which there are substantial grounds for difference of opinion, and

an immediate appeal from the order may materially advance the ultimate determination of the litigation; and it is further

ORDERED that plaintiff, Eugene W. Landy's motion for reargument of the Opinion entered September 13, 1971, is denied without costs.

DATED: December 1, 1971.

LAWRENCE A. WHIPPLE
U.S.D.J.

Opinion of Third Circuit Court of Appeals
Filed July 30, 1973

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

Nos. 72-1202, 1203, 1204

EUGENE W. LANDY, GLORIA LANDY, HARRY GROSS AND FREEHOLD GLASS CO., INC., a corporation of the State of New Jersey, individually and on behalf of all the Shareholders of the Eatontown National Bank, in Receivership, and derivatively on behalf of the Eatontown National Bank

v.

FEDERAL DEPOSIT INSURANCE CORPORATION, Receiver for the Eatontown National Bank; DOUGLAS J. SCHOTTE; TPO INCORPORATED, a corporation of the State of New York; FILOR, BULLARD & SMYTH, a Partnership; MERRILL, LYNCH, PIERCE, FENNER & SMITH, INC., a corporation of the State of New York; BACHE & CO., INC., a corporation of the State of New York; GOODBODY & CO., a Partnership; HARRIS, UPHAM & CO., INC., a corporation of the State of New York; COWEN & CO., a Partnership; THOMSON & McKINNON AUCHINCLOSS, INC., a corporation of the State of New York; HALLE & STIEGLITZ, a Partnership; SPINGARN, HEINE & CO., a Partnership; HEROLD, KASTOR & GEROLD INCORPORATED, a corporation of the State of New York; STERN, LAUER & CO., a Partnership; WILLIAM A. CERTILMAN, NED H. ELGART, KEITH GALLI, BURT CUTLER, EMMETT COX, HARVEY KATZ, WALTER SIMMONS, FRANK PALUMBO, NOR-

MAN MORRIS, FRANK DEVLIN, MAX ZYNOTOW, JOHN CLEVENGER, JAMES PERRY, ARTHUR GRANT, ALFRED BENJAMIN, JR., MAX HEINE, FEDERAL RESERVE BANK OF NEW YORK, an instrumentality of the United States Government; NATIONAL STATE BANK OF ELIZABETH, a national banking association; and EDWARD R. BURT & COMPANY, certified public accountants, NEW YORK STOCK EXCHANGE, an association, and SINGER, KAPLAN, RIPPEL & BURLEY, INC., a corp. of N.Y.

EUGENE W. LANDY, GLORIA LANDY, HARRY GROSS and FREEHOLD GLASS CO., INC.,

Appellants in No. 72-1202

FEDERAL DEPOSIT INSURANCE CORPORATION, Receiver of the Eatontown National Bank,

Appellant in No. 72-1203

GLORIA LANDY, HARRY GROSS and FREEHOLD GLASS CO., INC.,

Appellants in No. 72-1204

APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE DISTRICT OF NEW JERSEY

(D.C. Civil Action No. 1561-70)

Argued January 16, 1973

Before: KALODNER, ADAMS, and ROSENN, *Circuit Judges.*

Counsel for Appellants

Eugene W. Landy, Esquire (Pro Se)

Richard M. Phillips, Esquire
Alan J. Berkeley, Esquire
Cherif, Sedky, Esquire
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(Bache & Co., Inc.)

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Stryker, Tams & Dill
(New York Stock Exchange)

Mark F. Hughes, Jr., Esquire
Kraft & Hughes
(Cowen & Co.)

Ronald M. Sturtz, Esquire
Hannoch, Weisman, Stern & Besser
(Edward R. Burt & Co., Halle & Stieglitz; and Stern, Lauer & Co.)

Allan H. Klinger, Esquire
Calissi, Klinger, Cuccio & Baldino
(Filor, Bullard & Smyth, a partnership)
Paul, Weiss, Rifkind, Wharton & Garrison
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Samuel Kaufman, Esquire
Kaufman, Kaufman & Kaufman
(TPO Incorporated)
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Gary L. Falkin, Esquire
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(James Perry)

John Warren, Jr., Esquire
Parsons, Canzona, Blair & Warren
(Federal Deposit Insurance Corporation)

Bernard A. Schwarz, Esquire
(Spingarn, Heine & Co. and Max Heine)

James A. Hession, Esquire
Schumann, Hession, Kennelly & Dorment

Denis McInerney, Esquire
Cahill, Gordon, Sonnett, Reindel & Ohl

OPINION OF THE COURT

(Filed July 30, 1973)

ROSENN, *Circuit Judge.*

An incredible misuse of funds in stock market speculation[1] by Douglas Schotte, president of the Eatontown

1. The criminal convictions of several of the key malefactors have already been affirmed by this court. United States v. Schotte, No. 72-1834 (3d Cir. December 15, 1972); United States v. Certilman, No. 72-2128 (3d Cir. April 24, 1973). A related appeal involving a claim by one of the brokerage houses that the FDIC improperly refused to honor certified checks issued by ENB was presented in TPO Incorporated v. FDIC, No. 72-1424 (3d Cir. June 28, 1973).

National Bank (ENB), rapidly culminated in its financial collapse. This appeal involves a series of complex issues spawned by that catastrophe. The appellants, four named plaintiffs in the district court, brought suit in the District of New Jersey under the federal securities laws on behalf of themselves as purchasers of ENB's shares between January 1, 1967, and August 8, 1970, on behalf of the class of all other shareholders of the bank who purchased stock during that period, and derivatively on behalf of the now defunct bank.[2] The appellants are Eugene Landy, a bank director, Gloria Landy, his wife, Harry Gross, his wife's uncle, and Freehold Glass Co., Inc., Gross's corporation.

The United States Comptroller of the Currency closed ENB on August 8, 1970, after the discovery of the vast misappropriations of funds. According to appellants' complaint, Schotte devised a simplistic scheme of speculation in the securities market, hoping euphorically that the stocks purchased would rise in value prior to the time for payment. Without any authorization, he traded in the name of the bank and covered his losses with cashier's checks issued without consideration to the bank. Apparently, Schotte delayed payment for the purchased securities until the brokers pressed him, a delay often considerable because of a mixture of broker backroom office problems and their desire to retain Schotte's burgeoning business. When pressed for payment, Schotte either sold the stock if it had appreciated or issued a cashier's check signed by him as president of ENB. He allegedly concealed the scheme by making false statements to the shareholders and causing ENB to issue false financial statements. The scheme failed, leaving ENB with a devastating loss estimated at four million dollars.

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2. According to the complaint, plaintiff Eugene W. Landy purchased approximately 5,573 shares during this period. Gloria Landy, approximately 2,237 shares, Harry Gross, 1,889 shares, and Freehold Glass Co., Inc., 1,070 shares.

The defendants in this suit are:

(1) Twelve brokerage firms that opened accounts and executed transactions with Schotte, and sixteen individuals associated with these brokerage firms;

(2) The New York Stock Exchange (NYSE);

(3) The National State Bank of Elizabeth, New Jersey (the Elizabeth Bank);

(4) The Federal Reserve Bank of New York (the Reserve Bank);

(5) Edward R. Burt & Co. (Burt), a firm of certified public accountants;

(6) The Federal Deposit Insurance Corp. (FDIC) in its capacity as receiver for the Eatontown Bank; and

(7) Douglas Schotte.

Schotte and the FDIC, as receiver (standing in for the defunct bank), are allegedly liable under section 10 of the Securities Exchange Act of 1934, 15 U.S.C. § 78j, and rule 10b-5 promulgated thereunder, 17 C.F.R. § 240.10b-5, as a result of the scheme and false representations.

As to the brokers and firms, the complaint avers: they are liable under rule 10b-5, and, independently liable, for violation of the New York Stock Exchange "know your customer" rule and regulations of the Board of Governors of the Federal Reserve System; they allowed Schotte to open accounts in violation of the National Banking Act; they knew that the accounts were a part of a scheme to defraud the shareholders; they knew Schotte was not acting in a fiduciary capacity as he purported; they allowed the fraud to continue in order to garner the commissions generated, ultimately aggregating three million dollars; and four individual brokers made misleading statements to the appellants.

The complaint alleges that the Elizabeth Bank was the correspondent bank for ENB and provided its computer services. When Schotte would issue the cashier's checks

without depositing the necessary funds, the payee would deposit the checks in its bank and they would be cleared through the Reserve Bank. Although ENB did not have the requisite funds to cover the checks and pay the Reserve Bank, Schotte induced the Elizabeth Bank to somehow credit an ENB account with the funds necessary to pay the Reserve Bank. The complaint also alleges that: Schotte was in some manner able to return the same check as many as four or five times and have funds credited at the Elizabeth Bank; the Elizabeth Bank was negligent in handling the ENB account; the funds created by the Elizabeth Bank did not appear on the ENB books, thus allowing Schotte to misappropriate approximately four million dollars; and the returned cashier's checks were manually processed, and the daily statements of account of ENB revealed to the Elizabeth Bank the misuse of the account.

The complaint also alleges that the Reserve Bank was liable because it continued to process and reprocess the same cashier's checks, thus allowing payment for checks with the same or similar checks. The actions were allegedly negligent, violated contractual agreements with ENB, and violated the Reserve Bank's own rules and regulations.

The firm of Edward R. Burt & Co. prepared certified financials for ENB in the years 1967, 1968, 1969, and 1970. In addition, they were retained to conduct four partial examinations of ENB on a surprise basis each year. They allegedly issued an erroneous certification of the condition of the bank, which constituted a misstatement in violation of rule 10b-5, negligence under the New Jersey common law, and a breach of duty of care owed the shareholders. The certified financial statements, in reliance on which plaintiffs claimed to have purchased their shares, were also alleged to be false and misleading because they failed to state important facts.

The New York Stock Exchange is allegedly liable for willfully failing to enforce its rules pertaining to members. It allegedly allowed member firms to operate with incom-

plete records and lost securities. Plaintiffs say the records are in such disorder that it is impossible to trace the approximately two hundred million dollars in securities traded by Schotte or to determine whether the securities held by the brokers are actually assets of ENB. Moreover, according to the complaint, it would have been impossible for Schotte to perpetrate the fraud if the Exchange enforced its rules 410, 415-21, and 425 on proper record-keeping, and had it enforced rule 325 requiring the brokerage firms to maintain an adequate capital base.

Appellants sued the various defendants in a number of capacities. All defendants except the Elizabeth Bank, the Reserve Bank, and the NYSE were sued by the plaintiffs on behalf of themselves, derivatively on behalf of the bank, and on behalf of the class of all stockholders who purchased during the relevant period. The three designated defendants were sued only derivatively. In addition, the brokers' liability for violations of Federal Reserve Board regulations was asserted only derivatively.

In an opinion and order dated September 9, 1971, the district court denied the motions of the FDIC and Burt (except insofar as suit was brought against them derivatively) to dismiss the complaint, but granted similar motions by the brokers, the Elizabeth Bank, the Reserve Bank, and the NYSE. Schotte made no motion. In an opinion and order dated December 9, 1971, the district court granted Burt's motion to dismiss the class action against it, granted its motion for summary judgment against Gloria Landy, Gross, and Freehold Glass, and denied summary judgment against Eugene Landy. Plaintiffs have appealed from the aforesaid orders and judgments, except from the dismissal of the class action.[3]

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3. Jurisdiction for this appeal from the dismissal of less than all the counts of plaintiffs' complaint is based on 28 U.S.C. §1291 and the determination of the district court in its order of December 1, 1971, pursuant to F.R.C.P. 54(b), "that there is no just reason for delay" and therefore "expressly direct[ing] the entry of final judgment dismissing Counts 3 through 33, inclusive, and Counts 35 through 41 inclusive."

The district court further certified that his interlocutory orders denying dismissal of Counts 1, 2 and 34 involved controlling questions of law, pursuant

These decisions left standing only the claim of Eugene Landy against defendant Burt and the claims of the named plaintiffs as individuals and on behalf of the class against the FDIC as receiver and against Schotte. Subsequent to the district court decisions in this case, the FDIC, as receiver, initiated a suit on behalf of the bank against defendant corporate brokers, several additional brokerage firms, and accountant Burt.[3A]

We affirm the orders of the district court except that part of the order of September 9, 1971, dismissing the derivative counts against the parties not named as defendants in the suit since brought by the FDIC, as receiver.

We will consider the multiplicity of issues involved in the claims brought by the various plaintiffs in their varying capacities against the many defendants in the following order:

I. Can any of the claims be brought derivatively?

II. As to the claims brought by the plaintiffs individually, was the district court disposition of them correct as to

A. the brokers,

B. the accountants.

No separate discussion of the claims against the Elizabeth Bank, the Reserve Bank, or the New York Stock Exchange is included as those claims are all brought derivatively. There is also no separate discussion of the validity of the class action in light of our disposition of the individual claims.

(3. Continued)
to 28 U.S.C. §1292; but the FDIC does not now appeal the denial of its motion to dismiss plaintiffs' complaint against it, and Burt does not appeal the denial of summary judgment as to Mr. Landy.

3A. The original complaint in the suit instituted by the FDIC was filed in the United States District Court for the District of New Jersey on February 8, 1972. A first amended complaint was filed on August 7, 1972, and a second amended complaint was filed on June 6, 1973.

I. THE DERIVATIVE CLAIMS

A threshold question in this multi-faceted suit is whether the plaintiffs can maintain a derivative action on behalf of ENB in the absence of a demand upon it to bring suit. Plaintiffs brought derivative actions against each of the brokerage firms named as defendants, the individual brokers, and all others named as defendants in the first 30 counts of their complaint. They also brought derivative actions against the accountant, the NYSE, the Elizabeth Bank, the Reserve Bank, and the FDIC, the latter as a nominal defendant in its capacity as receiver. In their original complaint, they explained their failure to request institution of this suit by the FDIC as follows:

> Because of the receivership of the Eatontown National Bank, no demand can be made upon the shareholders to bring this action, nor upon the directors of the Eatontown National Bank. Further, the Federal Deposit Insurance Corporation, in its role as creditor, will be in a conflict of interest with its role as Receiver in pursuing the aforesaid claim.

The district court dismissed as "premature" the derivative causes of action on behalf of ENB against all defendants on the ground that plaintiffs, as shareholders of ENB, had no standing to institute suit in its behalf in the absence of a demand on and a refusal by the FDIC to bring such suit, as well as a failure to show why such demand need not have been made. It rejected plaintiffs' allegation that the FDIC's built in conflict of interest could serve as a basis for their derivative action because to do so would "severely restrict Congressional intent expressed in 12 U.S.C. § 1821(d)."

As a general principle, the responsibility for determining whether or not a corporation shall enforce in the courts a cause of action for damages is, like other business questions, ordinarily a matter of internal management left to

the discretion of the directors, *United Copper Co. v. Amalgamated Copper Co.*, 244 U.S. 261, 263-264 (1917). Otherwise a litigious stockholder could easily intrude upon authority of those who are vested with responsibility for the operation of the corporation's business. Whether to forego an action or to bring suit for damages is a matter of business judgment. Such decision may involve not merely a consideration of legal principles but a balancing of business interests and relationships.[4] The rationale of this principle is reflected in Rule 23.1 F.R.C.P. which provides, in substance, that a stockholder may not bring a derivative action to enforce a right of the corporation against a third party unless (1) the corporation has failed to enforce a right which might properly be asserted by it, and (2) the complaint alleges "with particularity the efforts, if any, made by the plaintiffs to obtain the action he desires from the directors or comparable authority . . . , and the reasons for his failure to obtain the action or for not making the effort."[5]

On appeal, the plaintiffs urge that the district court erred in dismissing their derivative action because the defrauded ENB shareholders are not required to make demand upon the bank receiver to bring the suit or to rely upon it to prosecute their derivative claims, when, as in

4. *See* Note, Demand on Directors and Shareholders as a Prerequisite to a Derivative Suit, 73 *Harv. L. Rev.* 746, 748 (1960)

> Since the corporation alone has standing to sue both insiders and outsiders for actionable wrongs committed against it, courts have been careful to regard the derivative suit as an extraordinary remedy, available to the shareholder, as the corporation's representative, only when there is "no other road to redress."

5. The pertinent provisions of the rule are:

> In a derivative action brought by . . . shareholders . . . to enforce a right of a corporation or of an unincorporated association, the corporation or association having failed to enforce a right which may properly be asserted by it, the complaint . . . shall also allege with particularity the efforts, if any, made by the plaintiff to obtain the action he desires from the directors or comparable authority and, if necessary, from the shareholders or members, and the reasons for his failure to obtain the action or for not making the effort. The derivative action may not be maintained if it appears that the plaintiff does not fairly and adequately represent the interests of the shareholders or members similarly situated in enforcing the right of the corporation or association.

this case, there are serious conflicts of interests between the FDIC and the shareholders. They argue the conflict of interest rendered a demand by ENB's shareholders on the FDIC "presumptively futile" and they should be permitted to press their derivative claims independently of the FDIC without first having made demand.

They argue that the conflicts of interests are:

(1) The FDIC is a subrogee of the claims of ENB's depositors as the insurer of their accounts and is, therefore, a major creditor of ENB interested in recovering only the amount necessary to pay the claims of depositors.

(2) The FDIC, as an insurer of the accounts of depositors of the Elizabeth Bank, has an interest in the solvency of that bank which may be endangered by this action. They further assert a conflict since FDIC supervises and regulates the Elizabeth Bank and might have an interest in concealing that which it failed to discover previously.

(3) Both the FDIC and the Reserve Bank are quasi-governmental agencies which, along with the Comptroller of the Currency, share the supervision of national banks. Two of the three directors of the FDIC are the Comptroller of the Currency and the Chairman of the Board of Governors of the Federal Reserve System, to which the defendant Reserve Bank belongs. Thus, it is "unrealistic to presume conclusively, as did the Court below, that the FDIC would as vigorously prosecute the claim against the Reserve Bank as would the Eatontown shareholders." As evidence of a reluctance of the FDIC to prosecute the Reserve Bank, they assert that the FDIC has already paid it a claim for approximately three million dollars in overdrafts in the ENB account. They note that the Comptroller of the Currency is charged with examinations of ENB which failed to disclose the secret trading by Schotte, and that he might want to cover up that activity at this time. They aver also that in the suit finally instituted by the FDIC, as receiver, subsequent to the commencement of this action,

the Elizabeth Bank and the Reserve Bank were not named as defendants.

The general rule is that a receiver may institute any suit on behalf of the corporation as the corporation itself might have commenced. *W. Fletcher, Cyclopedia of the Law of Private Corporations* § 7847 (1962 Revised Edition).

When a corporation is in receivership, any demand to bring suit in its behalf must be made upon the receiver rather than the directors. *See, e.g., Wachsman v. Tobacco Products Corp.*, 129 F.2d 815, 819 (3d Cir. 1942); *Long v. Stites*, 88 F.2d 554 (6th Cir.), *cert. denied*, 301 U.S. 706 (1937). This rule also applies to receivers of national banks. *See, e.g., Lucking v. Delano*, 129 F.2d 283 (6th Cir. 1942); *Wales v. Jacobs*, 104 F.2d 264 (6th Cir.), *cert. denied*, 308 U.S. 599 (1939); *Davis Trust Co. v. Hardee*, 85 F.2d 571 (D.C. Cir. 1936). "The receiver . . . becomes to all intents and purposes the bank—at least he stands in the place of the bank . . .; the receiver, after his appointment, represents the bank, its stockholders and creditors." *O'Connor v. Rhodes*, 79 F.2d 146, 148 (D.C. Cir. 1935). Section 1821(d) of 12 U.S.C.[6] generally directs that the

6. The pertinent provisions of § 1821(d) are as follows:

Notwithstanding any other provision of law, it shall be the duty of the Corporation as such receiver . . . to realize upon the assets of such closed bank, having due regard to the condition of credit in the locality; to enforce the individual liability of the stockholders and directors thereof; and to wind up the affairs of such closed bank in conformity with the provisions of law relating to the liquidation of closed national banks, except as herein otherwise provided. The Corporation as such receiver shall pay to itself for its own account such portion of the amounts realized from such liquidation as it shall be entitled to receive on account of its subrogation to the claims of the depositors, and it shall pay to depositors and other creditors the net amounts available for distribution to them. The Corporation as such receiver, however, may, in its discretion, pay dividends on proved claims at any time after the expiration of the period of advertisement made pursuant to section 193 of this title, and no liability shall attach to the Corporation itself or as such receiver by reason of any such payment for failure to pay dividends to a claimant whose claim is not proved at the time of any such payment. With respect to any such closed bank, the Corporation as such receiver shall have all the rights, powers, and privileges now possessed by or hereafter granted by law to a receiver of a national bank or District bank and notwithstanding any other provision of law in the exercise of such rights, powers, and privileges the Corporation shall not be subject to the direction or supervision of the Secretary of the Treasury or the Comptroller of the Currency.

FDIC as receiver shall enforce the individually liability of the stockholders and directors, wind up the affairs of the closed bank, and pay to the depositors and other creditors the net amounts available for distribution to them. It also provides that the FDIC shall have all rights, powers, and privileges granted by law to a receiver of a national bank or District bank. 12 U.S.C. § 1819 specifically confers the power to sue.

A derivative suit by shareholders should not be precluded merely because a bank is in the receivership of the FDIC. The FDIC would remain free to exercise its control over the winding up of the bank and to institute suit itself on behalf of the corporation. Congress has given no indication that it intended to preclude derivative suits by the shareholders of a national bank in receivership. When a receiver refuses to bring suit or "where it would be a vain thing to make a demand upon [it] and it is shown there is a necessity for a suit for the protection of the interests of creditors," a stockholder is free to sue. *O'Connor v. Rhodes*, 79 F.2d at 149, *aff'd sub nom. United States Shipping Board Merchant Fleet Corp. v. Rhodes*, 297 U.S. 383 (1936). Moreover, we agree with the statement that:

> To say that in every case the rule of exclusive power in the receiver is positive and admits of no exception, would be to sacrifice substantial rights to matters of form.

Id. at 148-49. We believe this case should be treated under the same principles applied to any derivative suit.

The allegations in plaintiffs' original and amended complaint, however, are merely general. The amended complaint alleges that a demand upon the FDIC would have been futile because, as receiver, it would be unable to sue because of its "conflict of interest between various government agencies and its regulatory and insurance functions." These allegations do not supply with particularity the reasons for failing to make the demand required by Rule

23.1. Instead of being "a statement of appropriate and convincing facts" that a demand would have been futile, *O'Connor v. Rhodes*, 79 F.2d at 148, it is merely a vague, conclusory statement.

Even had the plaintiffs averred with sufficient particularity, as required by Rule 23.1, their reasons advanced on appeal for failing to make a demand upon the receiver, we do not believe that the district court would have erred in dismissing the derivative claims as premature. We do not believe that even the reasons asserted on this appeal as grounds for relieving the plaintiffs of making demand upon the receiver to bring suit are adequate. In *Ash v. International Business Machines, Inc.*, 353 F.2d 491, 493 (3d Cir. 1965), we stated:

> The Supreme Court and, following it, the Courts of Appeals have repeatedly stated and applied the doctrine that a stockholder's derivative action, whether involving corporate refusal to bring anti-trust suits or some other controversial decision concerning the conduct of corporate affairs, can be maintained only if the stockholder shall allege and prove that the directors of the corporation are personally involved or interested in the alleged wrongdoing in a way calculated to impair their exercise of business judgment on behalf of the corporation, or that their refusal to sue reflects bad faith or breach of trust in some other way.

This principle enunciated in *Ash* applies with equal force to a national bank represented by a receiver mandated by congressional statute. Under the statutory schema created by Congress for our national banking system, the FDIC plays a vital role in the effective and efficient liquidation of insolvent national banks which is of far-reaching importance to the national government, the public, and the parties in interest. Reposed in it are broad powers, grave responsibilities, and delicate duties, all requiring the exercise of judgment and discretion. *See Liberty National*

Bank v. McIntosh, 16 F.2d 906 (4th Cir. 1927). "He [the receiver] acts for the stockholders in dealing with the assets," and may even ratify a liquidating contract for the bank in place of the shareholders. *Wegman v. National Bank of Commerce*, 51 F.2d 288, 290 (W.D.N.Y. 1931).

The first reason urged by defendants that FDIC, as a major creditor of ENB, has a conflict of interest which "could be extremely prejudicial to the interests of Eatontown's shareholders", flies in the face of Congressional directive. Congress has explicitly authorized the FDIC to act as receiver, 12 U.S.C. §1819, and has required the Comptroller to appoint the FDIC as receiver of any insured national bank which is closed. 12 U.S.C. §1821(c). Thus, under the federal banking laws the FDIC has the right to act for a closed (insolvent) bank and its stockholders. Moreover, in specifically providing in §1821(d) that the FDIC as receiver should ". . . pay to itself for its own account such portions of the amounts realized from . . . [the] liquidation as it shall be entitled to receive on account of its subrogation to the claims of depositors . . . ", Congress recognized that the FDIC would be functioning in the dual role of receiver and creditor. The FDIC's role as receiver had as the district court aptly observed, "[t]he primary objective . . . to marshal funds for distribution, a goal which would include *protection of shareholders.*" [Emphasis added.] Plaintiffs' argument that as shareholders of ENB they should not be compelled to rely upon the FDIC to prosecute their derivative claims is essentially predicated on the proposition that the FDIC is "a major creditor of Eatontown" and as such its interest in recovering against defendants will be "limited to its losses arising out of the payment of the insurance claims of Eatontown's depositors." Implicit in this argument is the assumption that the FDIC will not carry out its statutory duties as receiver, obligations which transcend the interests of both creditors and stockholders. We will not make such

a presumption in the absence of factual allegations supporting it.

The second reason advanced by plaintiffs, namely that the FDIC, as an insurer of the Elizabeth Bank, has a conflicting interest in its solvency, is also without merit. Nothing in this record intimates that a recovery against the Elizabeth Bank would in any way threaten its solvency or have an adverse impact on the FDIC, or that any other obligation of the FDIC would prevent or inhibit it from properly performing its statutory obligations.

We also find insufficient the third reason urged by plaintiffs, that the FDIC would not as vigorously press the claim against the Reserve Bank as would the ENB shareholders since both are "quasi-governmental agencies" and since directors on the Board of the FDIC have conflicting responsibilities in the Federal Reserve System and in the supervision of national banks.

Plaintiffs have attempted to substantiate their conflict of interest argument by asserting that two of the three directors of the FDIC are the Comptroller of the Currency and the Chairman of the Board of Governors of the Federal Reserve System. The Reserve Bank disputes the accuracy of the allegation that the Chairman of the Board of Governors of the Federal Reserve System is one of the three directors of the FDIC. Section 1812 of 12 U.S.C. provides that management of the FDIC "shall be vested in a Board of Directors consisting of three members, one of whom shall be the Comptroller of the Currency, and two of whom shall be citizens of the United States to be appointed by the President, by and with the advice and consent of the Senate." No designation whatsoever is made of the Chairman of the Board of Governors of the Federal Reserve System. By virtue of the foregoing statute, control of the FDIC Board of Directors could be in the two citizen members. Moreover, § 1821(d) expressly guards the FDIC as receiver of closed banks from supervision by the Comptroller of the Currency:

> [I]n the exercise of such rights, powers, and privileges the Corporation shall not be subject to the direction or supervision of the Secretary of the Treasury or the Comptroller of the Currency.

The mere presence under these circumstances on the Board of Directors of the FDIC of the Comptroller of the Currency does not per se constitute an inhibiting conflict of interest, especially in the absence of any specific allegation of the Comptroller's wrongful supervision of ENB which he might now desire to cover up, or of his bad faith as to any aspect of this litigation.

Developments since this case was heard by the district court suggest, however, that the question of the propriety of derivative claims against some of the defendants should be remanded for further consideration by the district court. When this matter was originally heard, "the receiver . . . stated to the court that it does in fact intend to bring suit against all parties responsible for the collapse of the bank. Until that representation is either contradicted by specific acts or inaction or until plaintiffs make a demand upon the FDIC they are without standing to pursue the matter independently." (District Court opinion of September 9, 1971). Appellants have in their brief called to our attention that the FDIC has brought suit against many of the defendants named in this action since the district court's entry of its order of dismissal, but has not named the Elizabeth Bank, the Reserve Bank, Schotte, the NYSE, and some of the brokers as parties. *See* note 3A *supra*. This statement is conceded in the joint brief of appellee brokers and the briefs of the FDIC and the Reserve Bank and is controverted by none of the appellees.

Normally, the court of appeals will consider only the record and facts considered in the district court. We specifically held in *Jaconski v. Avisun Corporation*, 359 F.2d 931, 936 n.11 (1966), that:

> We can consider the record only as it existed at the time the court below made the order dismissing the action.

See also Dictograph Products Company v. Sonotone Corporation, 231 F.2d 867 (2d Cir. 1956), *petition for certiorari dismissed by stipulation*, 352 U.S. 883 (1956); Rule 10(a), Federal Rules of Appellate Procedure.[6A] Neither *Jaconski* nor *Dictograph Products Company*, however, involved the right of an appellate court to take judicial notice of developments in the proceeding since the appeal was lodged.

The normal rule is subject to the right of an appellate court in a proper case to take judicial notice of new developments not considered by the lower court. 31 C.J.S., *Evidence* § 13, at 842 (1964).[6B] The credibility of witnesses is not here involved. In *Bryant v. Carleson*, 444 F.2d 353 (9th Cir. 1971), the Ninth Circuit recognized this limited exception in taking judicial notice of developments since the appeal, including filings, motions and orders in the district court and court of appeals, relevant administrative action of the Administrator of the United States Department of Health, Education and Welfare, and a decision of the California Supreme Court in a related matter. *See also United States v. Verlinsky*, 459 F.2d 1085 (5th Cir. 1972); *Kalimian v. Liberty Mutual Fire Insurance Company*, 300 F.2d 547 (2d Cir. 1962). In *Kirby v. Pennsylvania Rr. Co.*, 188 F.2d 793, 795 (3d Cir. 1951), this court took judicial notice of a

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6A. Rule 10(a) provides:

> (a) COMPOSITION OF THE RECORD ON APPEAL. The original papers and exhibits filed in the district court, the transcript of proceedings, if any, and a certified copy of the docket entries prepared by the clerk of the district court shall constitute the record on appeal in all cases.

6B. In Funk v. Commissioner, 163 F.2d 796, 800-801 (3d Cir. 1947), this court stated:

> [C]ourts will not travel outside a record in order to notice proceedings in another case, even between the same parties in the same court, unless the proceedings are put in evidence. . . . However, exceptions are admitted, and it may indeed be more appropriate to say that the extent to which the doctrine will be applied depends to a large degree upon considerations of expediency and justice under the particular circumstances of a case, as well as upon what it is that a court is asked to notice. See 9 Wigmore on Evidence (3rd Ed. 1940) § 2579.

paper describing the operation of the Railroad Adjustment Board, although acknowledging that the paper was "not in the record." *See also Parliman v. Delaware, L. & W. Rr.*, 163 F.2d 726, 730 (3d Cir. 1947); *United States v. Monjar*, 154 F.2d 954, 956 (3d Cir. 1946).

Judicial notice is frequently taken, of course, of developments not of record subsequent to a lower court decision in the application of the mootness doctrine by appellate courts. *See, e.g., Johnson v. New York State Education Department*, 409 U.S. 75 (1972) (matter called to court's attention in one of the parties' briefs); *Bethlehem Mines Corp. v. United Mine Workers*, No. 72-1466 (3d Cir. 1973). In the case sub judice, the justification for taking judicial notice is even greater because the subsequent developments were in the very court in which this suit was instituted, in a related matter, and merely involved notice of the filing of the new action and the parties thereto. This situation is similar to *Pittsburgh Newspaper Printing Pressman's Union v. Pittsburgh Press Co.*, No. 72-1496 (3d Cir. May 25, 1973), in which we took judicial notice of subsequent proceedings in the court of appeals and arbitration. We also note that rule 201(f) of the *Proposed Rules of Evidence for United States Courts and Magistrates*, as explained by the Advisory Committee's Note, provides that judicial notice may be taken at any stage of the proceeding, even on appeal. 56 F.R.D. 183, 206.

We therefore take judicial notice of the complaint filed by the FDIC. Appellants suggest that we should consider on this appeal the subsequent developments in deciding the appropriateness of a derivative suit. We think it appropriate, however, to remand to the district court rather than decide this issue now. This is the course the Supreme Court adopted in *Johnson v. New York State Education Department*, 409 U.S. 75 (1972), in determining whether a controversy had become moot subsequent to the lower court's decision.

Under these circumstances and to serve judicial economy, we will remand to the district court for consideration of the derivative action as to the parties not sued by the FDIC. While we indicate no opinion as to the merits of the claims, we see no useful purpose at this stage in requiring future demand by plaintiffs upon the FDIC to institute action against the defendants not sued by the FDIC. The FDIC had notice of plaintiffs' desire to sue these parties when it originally filed its complaint; the FDIC has indicated its position by not naming them as parties defendant. On the other hand, the record in this case reveals that plaintiff-appellant Landy, a trust officer, Vice President, and a director of ENB, has also been named as defendant in an action brought by other shareholders in which recovery is sought from directors of ENB for negligence. Remand to the district court for consideration of the maintenance of a derivative suit with respect to these parties subject to compliance with the other pertinent requirements of Rule 23.1 is appropriate. In this connection, the district court, in the exercise of its discretion whether to allow a new derivative suit as to these defendants should consider, *inter alia*, whether:

(1) the refusal of the FDIC to sue them is justified, *see, e.g., Kauffman v. Dreyfus Fund, Inc.*, 434 F.2d 727, 734 (3d Cir. 1970); *Groel v. United Electric Co.*, 70 N.J. Eq. 616, 61 A. 1061 (Ch. N.J. 1905);

(2) the other requirements of Rule 23.1 are met, including the related questions as to whether plaintiff-appellant Landy has a conflict of interest as a former director, officer, and counsel for ENB and as a defendant now in another action growing out of the insolvency of ENB, *see, e.g., Nolen v. Shaw-Walker Co.*, 449 F.2d 506 (6th Cir. 1971); *Eisen v. Carlisle & Jacquelin*, 391 F.2d 555 (2d Cir. 1968); *Quirke v. St. Louis-San Francisco Ry. Co.*, 277 F.2d 705 (8th Cir. 1960);

(3) the failure of the FDIC to resist, when it allegedly had grounds to do so, a claim of the Reserve Bank for approximately three million dollars in overdrafts in the account of ENB, substantiates appellants' claim of conflict of interest.

We emphasize that in remanding this portion of the case we do not reverse the district court or find error in its determinations. The district court's decision was carefully limited to the facts as they appeared at the time of its decision.

We therefore affirm the district court's dismissal of all derivative claims except those asserted against those defendants not sued by the FDIC. We need not consider the merits, therefore, of the claims against the NYSE, the Elizabeth Bank, and the Reserve Bank, as well as the possible brokers' liability for violations of Federal Reserve regulations and the National Banking Act, as those claims are brought derivatively only.

II. INDIVIDUAL STOCKHOLDER SUITS

A. The Brokers

The district court, relying on *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952), reasoned that to have standing to bring a suit under rule 10b-5 a plaintiff must have been a purchaser or seller in connection with the fraudulent scheme alleged. It noted that plaintiffs alleged two fraudulent schemes: first, in connection with Schotte's purchase and sale of approximately two hundred million dollars in securities in the name of ENB, and, second, in connection with shareholder purchases of ENB shares. As to the former, the court held that plaintiffs could not sue because they were not purchasers from or sellers to the brokers. As to the second, it held that any fraudulent scheme by the brokers was not closely enough related to the actual sale of ENB shares to be a fraudulent scheme within the terms of rule

10b-5. The crucial factor, according to the district court, was that Schotte's scheme in which the brokers were implicated was not predicated on the rise or fall of ENB shares. The court concluded that the brokers owed no duty to the plaintiff shareholders to disclose Schotte's activity as there was no participation by the brokers in any misrepresentation and the brokers were not corporate insiders or persons otherwise endowed with special status that might obligate them to disclose.

The district court also noted that the depositions did not disclose any affirmative misrepresentations by the brokers to anyone, ENB director Landy included; they merely showed that the brokers, in talking with Landy, failed to volunteer information as to the scheme. The court rejected the argument that there was liability for aiding and abetting Schotte in his scheme. It stated that the facts alleged were insufficient to connect the brokers with the alleged fraud against the shareholders and that the fraud relating to the two hundred million dollars was fraud against the ENB, not its shareholders.

Consideration of the alleged broker liability involves the following issues:

1. Are the brokers liable under rule 10b-5 in connection with
   a. the two hundred million dollar fraudulent scheme, or
   b. the purchase of ENB shares?
2. Are the brokers liable for violation of NYSE rule 405?

The issues will be discussed in that order.

1. Rule 10b-5 Liability

Rule 10b-5 provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5.

It is clear from the rule that a violation cannot occur unless the elements of subsections (a), (b), or (c) are present "in connection with the purchase or sale of any security." The district court correctly concluded that there were only two possible purchases or sales to which rule 10b-5 might arguably apply.

a. The Two Hundred Million Dollar Scheme

The complaint alleged a scheme to defraud in connection with the purchase and sale of approximately two hundred million dollars in securities. The threshold question is whether the scheme alleged is one which rule 10b-5 was designed to cover. In *Birnbaum*, the plaintiffs brought a derivative and shareholder class action bottomed on the same broad theory proposed in the case sub judice. The court dismissed the action on the two interrelated grounds that: (1) "[section 10(b)] was directed solely at that type of misrepresentation or fraudulent practice usually associated with the sale or purchase of securities rather than at fraudulent mismanagement of corporate affairs," and (2) "Rule X-10B-5 extended protection only to the defrauded purchaser or seller." 193 F.2d at 464.

In the case sub judice, there is some question whether the fraudulent scheme of Schotte and the brokers was the type "usually associated with the sale or purchase of securities" rather than mere fraudulent mismanagement of corporate affairs. Since *Birnbaum*, the scope of rule 10b-5 has been gradually and greatly expanded:

> In its evolution to date, 10b-5 has become a powerful, if slightly erratic, tool in the enforcement of fiduciary duties. It continues to operate independently of them, as well as with them, and to be based on parallel considerations of the unfairness of insiders' taking personal advantage of their corporate position . . . . Unquestionably, 10b-5 in derivative cases is contributing to investor protection in the general sense of preserving their shares from value loss because of insider abuses. Whether, or how much, it should do that, is another matter.

A. Bromberg, Securities Law: Fraud § 4.7(2) (1968) (footnotes omitted).

In *Superintendent of Insurance v. Bankers Life & Casualty Co.*, 404 U.S. 6 (1971), the Supreme Court gave some indication how far rule 10b-5 extends to protect against corporate mismanagement. In *Bankers Life*, the Superintendent of Insurance of New York, as liquidator of Manhattan Casualty Company (Manhattan), commenced an action against ten defendants alleging fraud. One of the defendants, Bankers Life & Casualty Co., agreed to sell all of Manhattan's stock to one Begole for five million dollars. The complaint alleged that Begole conspired with one Bourne and others to pay for the stock with Manhattan's assets. They allegedly arranged, through Garvin, Bantel & Co., a note brokerage firm, to obtain a five million dollar check from Irving Trust Co., although they had no funds on deposit there at the time. On the same day they purchased all the stock of Manhattan from Bankers Life for five million dollars and installed one Sweeney as presi-

dent of Manhattan. Manhattan then sold its United States Treasury bonds for $4,854,552.67.

Manhattan's Board of Directors was apparently deceived into authorizing the bond sale by a misrepresentation that the proceeds would be exchanged for a certificate of deposit of equal value. The money, however, plus enough cash to bring the total to five million dollars, was credited to an account of Manhattan at Irving Trust, and the five million dollar Irving Trust check was charged against it. Begole thus owned all of Manhattan's stock, having used Manhattan's assets to purchase it.

To complete the fraudulent scheme, Manhattan procured from Irving Trust a second five million dollar check. Sweeney, Manhattan's new president, tendered this check to Belgian-American Bank & Trust Co., which issued a five million dollar certificate of deposit in the name of Manhattan. Sweeney endorsed the certificate of deposit over to New England Note Corp., which was controlled by Bourne. Bourne then procured a five million dollar loan from Belgian-American, using the certificate as collateral and paying the proceeds to Irving Trust to cover Manhattan's five million dollar liability to them.

Manhattan's books reflected the purchase of the certificate of deposit but did not reflect its assignment to New England and its pledge to Belgian-American. The books, thus, did not show that Begole had used Manhattan's assets to purchase its stock.

The district court and the court of appeals in *Bankers Life* held that the plaintiff did not state a cause of action under rule 10b-5 against Bankers Life and certain other corporate defendants. The court of appeals relied on the first *Birnbaum* requirement. It dismissed the action because any deception that occurred did not affect the sales transaction and neither the purchaser nor the seller was defrauded as to the terms of the sale itself. "The fraud alleged in this case in no way affected either the securities market or the investing public . . . . The purity of the

security transaction and the purity of the trading process were unsullied." 430 F.2d 355, 361 (2d Cir. 1970). The court stated that section 10(b) "is limited to preserving the integrity of the securities markets." *Id.*

The Supreme Court reversed. It held that Manhattan was a seller within the meaning of rule 10b-5 and that there was an act within the meaning of the rule that operated as fraud upon Manhattan, the seller being duped into believing that it would receive the proceeds. The Court stated that it was irrelevant that it was the proceeds of the sale which were misappropriated in a transaction that could be separated from the actual securities transaction. 404 U.S. at 10. It reasoned that section 10(b) was not "limited to preserving the integrity of the securities markets", as the court of appeals panel had held. Instead, it held:

> Section 10(b) must be read flexibly, not technically and restrictively. Since there was a "sale" of a security and since fraud was used "in connection with" it, there is redress under § 10(b), whatever might be available as a remedy under state law.

Id. at 12. The only limitation in the decision was the concession that Congress did not intend to regulate transactions that constitute no more than internal corporate mismanagement. The crux of the case, however, that took it out of the realm of corporate mismanagement, was that Manhattan suffered an injury "as a result of deceptive practices touching its sale of securities as an investor." *Id.* at 12-13.

It appears, therefore, that the Supreme Court has severely limited the first *Birnbaum* requirement.[7] All that

7. Indeed, another panel of the Second Circuit also seems to have constricted the first *Birnbaum* requirement. In A.T. Brod & Co. v. Perlow, 375 F.2d 393 (2d Cir. 1967), a broker brought an action against certain of his customers for a recovery of losses suffered when they refused to pay for securities previously ordered but depreciated in value by the settlement date. It had been alleged that the customers planned to pay only for securities that had appreciated in value. The Second Circuit reversed the dismissal of the

is now required is injury to an investor caused by deceptive practices "touching" on the purchase or the sale of securities by that investor. That requirement may well be met in this case, but we must still inquire whether these plaintiffs have standing under the rule.

Although *Bankers Life* interpreted the *Birnbaum* requirement of a fraudulent practice in connection with purchase or sale of a security very broadly, it did not, as appellants argue, eliminate the purchaser or seller requirement. Plaintiff in *Bankers Life* was the Superintendent of Insurance, suing on behalf of Manhattan as its liquidator. In the alleged fraudulent scheme, it was Manhattan which sold the securities and was victimized by the fraud. There was therefore no question that Manhattan was a seller "in connection with" the sale of the securities. That, however, is not the factual situation in the present case. The four shareholder-plaintiffs were neither purchasers nor sellers of the two hundred million dollars in stock traded by Schotte through the ENB.[8] Nothing in *Bankers Life* indicates that the Court intended to abolish the purchaser or seller requirement for rule 10b-5 liability.[9]

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7. (Continued)
complaint, holding that an action under 10b-5 was not barred solely because the alleged scheme does not involve the type of fraud that is usually associated with the sale of securities. It believed that rule 10b-5 prohibits "*all* fraudulent schemes in connection with the purchase or sale of securities, whether the artifices employed involve a garden type variety of fraud, or present a unique form of deception." *Id.* at 397.

In *Bankers Life*, the Court reasoned that "misappropriation", as there involved, was actually the "garden type" referred to in *Birnbaum* as compared to the scheme in *Brod*, 404 U.S. at 11 n.7. The Court also relied upon two other cases giving rule 10b-5 a broad application, Allico National Corp. v. Amalgamated Meat Cutters & Butcher Workmen, 397 F.2d 727 (7th Cir. 1968); Cooper v. North Jersey Trust Co., 226 F. Supp. 972 (S.D.N.Y. 1964). *Id.*

In a recent case, Bush v. Masiello, 55 F.R.D. 72 (S.D.N.Y. 1972), the court held that the complaint stated a good 10b-5 cause of action with allegations that officers of a broker-dealer converted corporate funds in connection with the purchase and sale of securities.

8. The fraudulent scheme in connection with the plaintiffs' purchase of ENB shares is discussed separately, *infra*.

9. We need not decide and therefore express no opinion on the question of whether the brokers are liable to the ENB (i.e., the FDIC as receiver) under rule 10b-5. Disposition of that issue involves questions of whether the ENB was in reality a purchaser and seller, and whether the fraudulent scheme alleged here was of the type covered by rule 10b-5, even under the expansive definition of *Bankers Life*.

Our conclusion that the *Bankers Life* decision did not construe the scope of the purchaser or seller requirement in such a way as to allow suit by plaintiffs here is buttressed by examination of the many precedents in the lower federal courts. *Birnbaum's* limitation of liability to "only . . . the defrauded purchaser or seller" has been undergoing significant erosion, *Bromberg, supra*, at § 8.8 (1968); but, we find no persuasive precedent which would indicate so little of the requirement remains as to constitute liability to the individual shareholders here.

In *Kahan v. Rosenstiel*, 424 F.2d 161 (3d Cir.), *cert. denied*, 398 U.S. 960 (1970), this court held that a private party not a purchaser or seller, seeking *injunctive relief* for a 10b-5 violation does have standing if he can establish a causal connection between the violations alleged and his injury. *Id.* at 173; *accord, Mutual Shares Corp. v. Genesco, Inc.*, 384 F.2d 540 (2d Cir. 1967); *Britt v. Cyril Bath Co.*, 417 F.2d 433, 436 (6th Cir. 1969). The rationale was premised on the policy of the Securities Exchange Act to eliminate deceptive and unfair practices in security trading and to protect the public from inaccurate, incomplete, and misleading information, and to provide the public with the opportunity to make knowing and intelligent decisions regarding the purchase or sale of securities. A suit seeking an injunction against deceptive practices in security sales would promote a free and open securities market and protect prospective purchasers and sellers. An injunction suit, as distinguished from an action for damages, will therefore, in appropriate circumstances, be permitted under the rule even though the complainant is not a purchaser or seller.

Although various courts and commentators have suggested elimination of the purchaser-seller requirement,[10]

10. The same district court judge that decided this case, in a later case, Tully v. Mott Supermarkets, 337 F. Supp. 834, 840 (D.N.J. 1972), permitted a 10b-5 suit by stockholders who had neither purchased nor sold their stock but who alleged that certain directors and other stockholders fraudulently purchased treasury stock and gained control of the corporation. He noted that

each of the circuit court of appeals that has ruled on this question recently has affirmed the basic *Birnbaum* rule that standing under 10b-5 in a suit *for damages* requires purchaser-seller status.[11] The reasons for retaining the standing requirement are posited as essentially twofold: first, the purpose of Congress in enacting section 10(b) was merely to extend to sellers of securities the same protection that had been afforded to buyers under the 1933 Securities Act: second, only Congress should change an interpretation of an act unbroken since its passage. *See, e.g., Iroquois Industries, Inc. v. Syracuse China Corporation,* 417 F.2d 963 (2d Cir. 1969); *Herpich v. Wallace,* 420 F.2d 792 (5th Cir. 1970). Precise guidelines have not been formulated as to when the flexible view of 10b-5 will permit standing in the absence of technical purchaser or seller status, but the one criterion often reiterated is whether standing would effectuate the broad purpose of the rule. *See, e.g., Herpich v. Wallace,* 430 F.2d 792, 807 (5th Cir. 1970); *Kahan v. Rosenstiel,* 424 F.2d 161 (3d Cir. 1970).[12]

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10. (Continued)
the *Birnbaum* limitation on standing to sue was not found in the language of section 10(b) or rule 10b-5 and reasoned that the current trend among courts and scholars is away from the restrictive *Birnbaum* principle. Although faced only with a request for injunctive relief, he concluded that the only requirement is that plaintiffs' losses be caused by the alleged fraud. *Compare* Entel v. Allen, 270 F. Supp. 60, 70 (S.D.N.Y. 1970); Lowenfels, *The Demise of the Birnbaum Doctrine: A New Era for Rule 10b-5,* 54 U. Va. L. Review 268 (1968).

11. Iroquois Industries, Inc. v. Syracuse China Corporation, 417 F.2d 963 (2d Cir. 1969); Greenstein v. Paul, 400 F.2d 580 (2d Cir. 1968); Herpich v. Wallace, 430 F.2d 792 (5th Cir. 1970); Rekant v. Desser, 425 F.2d 872, 877 (5th Cir. 1970); Jachimiec v. Schenley Industries, Inc., No. 15024 (7th Cir.), *cert. denied,* 382 U.S. 841 (1965); Dasho v. Susquehanna Corp., 380 F.2d 262 (7th Cir.), *cert. denied sub nom.* Bard v. Dasho, 389 U.S. 977 (1967); Erling v. Powell, 429 F.2d 795 (8th Cir. 1970); City National Bank of Fort Smith, Ark. v. Vanderboom, 422 F.2d 221, 228 (8th Cir. 1970); Greater Iowa Corp. v. McLendon, 378 F.2d 783 (8th Cir. 1967); Mount Clemens Industries, Inc. v. Bell, 464 F.2d 339 (9th Cir. 1972); Jensen v. Voyles, 393 F.2d 131 (10th Cir. 1968).

12. The use of this indicium is consistent with the liberal application of the standing doctrine in certain areas to guarantee that remedies are available to effect congressional intentions. *See, e.g.,* J.I. Case Co. v. Borak, 377 U.S. 426, 433 (1964); Hanover Shoe, Inc. v. United Shoe Machinery Corp., 392 U.S. 481, 494 (1968); *cf.* Textile Workers v. Lincoln Mills, 353 U.S. 448, 457 (1957); Bell v. Hood, 327 U.S. 678, 684 (1946).

Numerous other cases exist in which the "purchaser-seller" language has been read flexibly. In *SEC v. National Securities, Inc.*, 393 U.S. 453 (1969), in its first expression involving rule 10b-5, the Supreme Court held that the action of shareholders in exchanging their shares for those of a company with which their company was merging was a "purchase" of the shares within the terms of the rule.[13] Since the action was brought by the SEC, the Court was dealing solely with the issue of statutory coverage, not standing, but there is no reason for a stricter definition of the "purchaser-seller" concept as it relates to standing.

In *Herpich v. Wallace*, 430 F.2d 792, the Fifth Circuit held that a corporation had standing as a purchaser on the basis of the action of the board of directors in merely *approving* a merger of the corporation that would involve the purchase by the corporation of securities. It reasoned that standing to seek damages in such circumstances would further the broad antifraud purposes of section 10(b) and rule 10b-5. *Id.* at 809. Similarly, corporate action in liquidating its assets so that the plaintiff-shareholder was left with worthless stock has been deemed to be a "sale" for rule 10b-5 purposes. *See, e.g., Dudley v. Southeastern Factors & Finance Corp.*, 446 F.2d 303 (5th Cir. 1971).

Plaintiffs also argue that *Bankers Life* and the foregoing cases expanding rule 10b-5 authorize their cause of action. We conclude, however, that permitting a cause of action to these plaintiffs would not be in keeping with the congressional purpose in enacting section 10(b); nor is it required by the interpretation in *Bankers Life*. When Congress enacted section 10(b), it did not contemplate the protection of every person injured by a fraudulent scheme in connection with the purchase or sale of securities. Its immediate concern was the protection of the purity of the informational system in the securities market. The

13. Kahan v. Rosenstiel, 424 F.2d 161 (3d Cir. 1970); Mutual Shares Corp. v. Genesco, Inc., 384 F.2d 540 (2d Cir. 1967); Britt v. Cyril Bath, 417 F.2d 433 (6th Cir. 1969).

broad language in *Bankers Life* is reconcilable with this purpose. It is not so broad, however, as to expand the class of protected persons to include these plaintiffs. Although the immediate legislative focus was to safeguard the informational atmosphere in the securities market from deceptive devices and enervating impurities, it must be acknowledged that the broader focus of the Securities Exchange Act was on protecting the investor and making the market place safe to trade. Equally disastrous to the investor would be schemes not involving misinformation but, nonetheless, directly related to the trading process, artifices leaving the investor with less than he bargained for. Thus, casting the seller who has parted with his securities but has been cheated of payment—as occurred in *Bankers Life*—to the vagaries of state law, the problems of state jurisdiction and service of process, would ill serve basic congressional policy. The Supreme Court in *Bankers Life* can be viewed as having exercised its inherent powers in developing a federal securities common law as a means of protecting the legislative scheme.

Rule 10b-5's expanded zone of interests under *Bankers Life* would, nevertheless, not encompass the plaintiffs' interests in this case. They did not engage in any market transactions with the defendants by which they sustained their losses. Were we to extend the provisions of section 10(b) beyond the buyer or seller relationship, we would be judicially extending the terms of the statute and creating new rights. The consequences of the view urged by plaintiffs would establish a new and amorphous body of rights and obligations heretofore unrecognized in federal jurisdiction. Buyer or seller status is indispensable in establishing liability for damages under rule 10b-5. Exceptional circumstances may arise in which a stockholder might have a cause of action due to fraud in connection with the stock he holds and has not sold; that situation is not before us.[14]

14. We make no decision here whether the FDIC, as receiver for the defunct bank has a right of action against the brokers under rule 10b-5.

Barring the plaintiffs from maintaining a private right of action is also consistent with the generally applicable rules of standing. Apart from Article III jurisdictional problems, the standing question involves rules developed by the judiciary in the exercise of self-restraint. *Association of Data Processing Service Organizations, Inc. v. Camp*, 397 U.S. 150, 154; *Barrows v. Jackson*, 346 U.S. 249, 255 (1953). Normally, standing is accorded only where "the interest sought to be protected or regulated by the complainant is arguably within the zone of interests to be protected or regulated by the statute or constitutional guarantee in question." 397 U.S. at 153. Because these plaintiffs are not within that zone, they have no standing to assert violations of rule 10b-5.

This conclusion is also consistent with the well established rule that injury flowing directly to the corporation does not create a primary right of action in shareholders. *See United Copper Securities Co. v. Amalgamated Copper Co.*, 244 U.S. 261, 263 (1917); *Ash v. International Business Machines, Inc.*, 434 F.2d 727, 732 (3d Cir. 1970).

Plaintiffs resourcefully advance the argument that they also have a right of action under the "forced seller" concept enunciated in *Vine v. Beneficial Corp.*, 374 F.2d 627 (2d Cir.), *cert. denied*, 389 U.S. 970 (1967), and its progeny, *Coffee v. Permian Corp.*, 434 F.2d 383 (5th Cir. 1970), and *Dudley v. Southeastern Factors & Finance Corp.*, 446 F.2d 303 (5th Cir.), *cert. denied sub nom. McDaniel v. Dudley*, 404 U.S. 858 (1971). These cases are inapposite.

In *Vine*, a Class A stockholder of Crown Finance Company, Inc., sued Beneficial Finance Co., Inc. He alleged that Beneficial acted in concert with the officers and directors of Crown to defraud its Class A stockholders by appropriating for Class B stockholders $900,000 which should have gone to Class A stockholders and by merging Crown into Beneficial for $800,000 less than fair market value. Beneficial effected the merger by acquiring 95 percent of the Class A shares through a tender offer and then, pur-

suant to state law, forcing the remaining minority stockholders to sell their shares for cash. The district court dismissed the complaint, holding the plaintiff was not a seller under rule 10b-5. The Second Circuit reversed, notwithstanding that plaintiff had not yet tendered his shares. The court reasoned that the corporation was at that point non-existent and that in order to realize any value for his stock the plaintiff "must now exchange his shares for cash" from the defendant. Plaintiff was therefore a "forced seller," a position he would not have been in were it not for the fraud perpetrated in the merger.

In *Coffee*, a minority shareholder claimed that his corporation had been substantially liquidated solely for the benefit of its 80 percent corporate stockholder. The district court dismissed a 10b-5 claim on the ground that plaintiff lacked standing because he was not a purchaser or seller. The Fifth Circuit, in an opinion written by visiting Judge Adams of this Circuit, reversed, holding that plaintiff's averments were sufficient to demonstrate standing as a seller, because, by virtue of the liquidation, his shares were converted into a claim for cash.

In *Dudley*, a shareholder in Southeastern Factor and Finance Corporation (SEFAF) sued the corporation, certain of its principals, its shareholders, and other corporations. He alleged that SEFAF's board of directors had adopted a fraudulent plan for the liquidation in which SEFAF's only substantive asset, its stock in First American Life Insurance Company, was to be traded for stock of Atlantic Services, Inc., which stock would be distributed to SEFAF's shareholders. The distribution of Atlantic stock was made but plaintiff received none of the shares. The district court dismissed the complaint on the ground that the plaintiff was not a purchaser or seller since he had no standing. The Fifth Circuit following *Coffee* reversed, holding that the plaintiff-shareholder was a "forced seller" because his "investment in a going enterprise has been commuted into a right . . . to a payment of money." 446 F.2d at 308.

Each of these "forced seller" cases possesses elements not present in the case before us. In each case, the majority shareholders of a corporation or other insiders were taking advantage of its minority shareholders. In each, the fraudulent scheme was an integral part of the forced sale and the transaction attacked. In each, the fraudulent scheme was directly related to and in connection with the forced sale. On the other hand, in this case the purpose of Schotte and the brokers was not to achieve a forced sale of the bank stock. The alleged fraud of the brokers was not in connection with the putative "forced sale" in the bank liquidation. Plaintiffs do not allege a federal securities law violation in connection with the "forced sale" in the bank liquidation. Their complaint is directed to alleged fraud of the brokers against ENB before they became "forced sellers" by virtue of the liquidation. To the extent that they are or may become forced sellers, it is only because of internal corporate management or of possible 10b-5 fraud imposed upon ENB as a corporate entity. Under these circumstances, we do not believe the broad purpose of the Act would be served by extending standing to these plaintiffs. Granting standing to them might confer standing to sue as "forced sellers" upon shareholders in any corporation in bankruptcy because of an unfortunate securities transaction. No case has gone so far, and we decline to do so.

b. The Purchase of ENB Shares

The complaint also alleged a scheme to defraud in connection with the purchase by plaintiffs of ENB stock. In determining whether the district court was correct in finding insufficient the allegations connecting the brokers to the sale of ENB shares, it is necessary to examine, first, what the connection was, second, whether the brokers owed any independent duty to disclose Schotte's scheme, and finally, whether the brokers were closely enough connected to the scheme to be liable as aiders and abettors of Schotte.

The complaint alleges that the brokerage firms employed a scheme to defraud the ENB shareholders "in connection with the purchase of shares of the Eatontown National Bank by the plaintiff shareholders." It avers that the firms "concealed the material fraud being perpetrated by the President of the Eatontown National Bank." The only other particularization of the brokers' connection with the sale states:

> The individual defendants, Burt Cutler, Harvey Katz, Alfred Benjamin, Jr. and Max L. Heine, between January 1, 1967 and August 8, 1970, and at various other times, made statements concerning the Eatontown National Bank to the shareholders of the Eatontown National Bank, including statements to the plaintiff, Eugene W. Landy. Said statements were false and misleading and omitted material facts since, at no time did they reveal the plan and scheme to defraud as aforesaid.

The district court noted that the only revelation at depositions elaborating upon these alleged affirmative misrepresentations was by plaintiff Landy, to the effect that the named brokers never volunteered to him that they were doing business with the bank. Landy never asked if they were, and the brokers never made any statements concerning the general nature of their activities.

The plaintiffs do not, on appeal, argue that in fact there was a closer connection between the sale of ENB shares and the brokers' activities. Instead, they argue that the brokers had a duty to disclose the illicit operations and that their silence was an integral part of Schotte's scheme to defraud them in the purchase of their ENB shares.[15]

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15. Appellants' brief at pages 23-24 argues that plaintiffs:

purchased their stock in reliance upon financial statements which showed a growing and profitable banking enterprise, but which did not disclose the secret trading and the impact of that trading on the financial condition

They argue that the definition in the *Bankers Life* case of the rule 10b-5 "in connection with" requirement mandates the conclusion that the brokers are liable to the shareholders in this case.

It is established that, in a case facing disposition on a motion to dismiss, the facts alleged in the complaint must be accepted as true. *Kahan v. Rosenstiel*, 424 F.2d 161, 164 (3d Cir. 1970). F.R.C.P. 12(b), however, provides that if a motion is made asking that the complaint be dismissed for failure of the pleadings to state a claim upon which relief can be granted, and matters outside the pleadings are presented to the court, the motion shall be treated as one for summary judgment under Rule 56, and parties shall be given reasonable opportunity to present all pertinent material. Under Rule 56(a) a party is entitled to summary judgment if there is no genuine issue as to any material fact and judgment is warranted as a matter of law. Rule 56(a) provides that an adverse party may not rest upon mere allegations in his pleading but must set forth specific facts. Thus, in this case, although the formal pleadings would appear to raise an issue of fact as to the brokers' connection with the sale of ENB shares, it is apparent from the depositions that no factual issue exists. Therefore, the question whether liability arises for fraud in connection with the purchase of ENB stock can be decided upon the supplemental factual pleadings. *Schwartz v. Associated Musicians, Local 802*, 340 F.2d 228 (2d Cir. 1964). There is no indication on appeal that plaintiffs desired to or could produce additional relevant evidence.

As we have already noted, *Bankers Life* expanded the coverage of rule 10b-5 over fraud "in connection with the

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15. (Continued)

of Eatontown. Concealment of the secret trading was not merely tangential to the scheme to defraud; it was essential to its furtherance and the injury to the purchasers of Eatontown common stock flowing from the failure to disclose was clearly forseeable. In the face of such a direct relationship between plaintiffs' injury, as purchasers of Eatontown common stock, and the scheme to defraud in which the defendant brokers participated, it was wholly arbitrary to divide, as did the Court below, the flow of events which led to plaintiffs' losses into two separate and distinct frauds.

purchase or sale of securities." It was unnecessary, however, for the Court to give precise definition to the term "in connection with" since the fraud there was directly related to the sale of the securities, depriving the corporation of the proceeds of the transaction. The pertinent question here is whether the brokers' alleged acts were "in connection with" plaintiffs' purchase of ENB shares.

A scheme deliberately calculated to manipulate the market value of a stock would be covered under the rule. *Crane Company v. Westinghouse Air Brake Company*, 419 F.2d 787 (2d Cir. 1969); *SEC v. North American Research & Development Corp.*, 280 F. Supp. 106 (S.D.N.Y. 1968). This follows easily from the language of the rule and from its purpose to protect investors. *Annot.* 3 ALR Fed. 819, 822. No such intent on the part of the brokers to manipulate ENB share prices, however, has been alleged in this case.

Notwithstanding the absence of such an intent, a scheme nonetheless may be proscribed by rule 10b-5 if it includes misrepresentation which may reasonably be relied upon by the average investor in purchasing or selling the securities in question. *Heit v. Weitzen*, 402 F.2d 909, 913 (2d Cir. 1968); *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 839 (2d Cir. 1968). This proposition, however, is not readily applicable to this case, since the allegations, at this stage, are not that the brokers did something upon which plaintiffs relied or could reasonably have relied, but, rather, that the brokers did not affirmatively inform plaintiffs that they were buying and selling securities for Schotte, which failure influenced plaintiffs' purchases and sales of ENB stock. The affirmative acts of the brokers, however, were not committed in connection with the purchase of ENB shares. The relationship between the two is remote, and no stretch of the imagination suggests that plaintiffs relied upon these acts in their purchase of ENB shares.[16] Nor

16. See discussion of these requirements in the section treating the accountants' liability, *infra*.

does the record show that the brokers knew plaintiffs were purchasing shares at the time of the scheme. Since the only connection shown to plaintiffs' purchases was the brokers' silence, the brokers cannot be liable to plaintiffs unless they were under some affirmative obligation to disclose the scheme.

Plaintiffs rely on *Brennan v. Midwestern United Life Insurance Co.*, 417 F.2d 147 (7th Cir. 1969), for authority that 10b-5 imposes a duty to disclose information relating to deceptive practices in connection with securities purchases. *Brennan*, however, should be distinguished. In *Brennan*, Midwestern Life had failed to disclose what it knew about fraudulent trading in its stock by a broker (Dobich), even though customers of the broker had made inquiries of Midwestern regarding the very matter. Instead of disclosure, Midwestern merely referred the customers to the broker or suggested that they pursue the matter with the Indiana Securities Commission. In the case now before us there were no specific requests or inquiries by plaintiffs of the brokers relating to the trading by the ENB. It is notable that the court in *Brennan* relied on silence after specific inquiry *plus* affirmative costs:

> It is our view that the district court was correct in concluding that Midwestern's acquiescence through silence in the fraudulent conduct of Dobich combined with its affirmative acts was a form of aiding and abetting cognizable under Section 10(b) and Rule 10b-5.

Id. at 154. *Brennan*, too, was premised on a theory of aiding and abetting the primary violator of rule 10b-5. The applicability of an aiding and abetting theory to this case is discussed below.

In the absence of a special relationship between the parties, no case has come to our attention imposing liability on the basis of "mere inaction." There is no basis in the

policy underlying the Securities Acts for extending rule 10b-5 liability in the situation presented by plaintiffs.[17]

In *Wessel v. Buhler*, 437 F.2d 279, 283 (9th Cir. 1971), the court rejected the very argument proffered here. It refused to impose liability upon accountant Jordan based upon mere inaction. Jordan had been retained by Rocky Mountain Chemical Corporation (RMC) to prepare three financial statements for specific, narrow purposes. RMC, unaided by Jordan, published a misleading prospectus which plaintiffs allegedly relied upon in purchasing RMC stock. They sought to impose liability upon Jordan for their losses on the ground that he owed a duty to prospective investors to disclose his knowledge of RMC's deficient financial records. In rejecting "this extraordinary theory," the court noted that the only mention in rule 10b-5 of liability for inaction is subsection (2) making it unlawful "to omit to state a material fact necessary in order to make *the statements made* . . . not misleading." [Emphasis added.] Also finding nothing in the congressional purpose underlying the Securities Exchange Act to justify imposition of liability, it concluded:

> the exposure of independent accountants and others to such vistas of liability, limited only by the ingenuity of investors and their counsel, would lead to serious mischief.

Id.

Nor has 10b-5 liability under an aiding and abetting theory been sufficiently alleged. Liability for aiding and abetting Schotte in his misstatements was not alleged in

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17. *See* Ruder, *Multiple Defendants in Securities Law Fraud Cases*, 120 U. Pa. L. Rev. 597, 644 (1972).

It is of course true that a broker possessing inside information about a corporation may have duties to (a) disclose the information to his clients trading in that corporation's securities, *see Bromberg*, § 5.2; and (b) refrain himself from trading in that corporation's securities, *see Bromberg*, § 5.6. Neither duty, however, is relevant in the present case.

Regarding the first duty, there is no allegation in this case that any of the plaintiffs were clients of the defendant-brokers in their purchases of ENB stock. As to the second duty, there is no allegation that the brokers themselves were trading in ENB shares.

the complaint but was treated by the district court and argued on appeal. The district court treated the allegation by saying:

> The aiding and abetting and conspiracy arguments are also ill-fated . . . . [T]he facts alleged in the present case simply cannot support such a theory. The fraud in which the brokers are alleged to have aided or conspired with Schotte was the fraud concerning the $200,000,000 in security transfers not the fraud against the shareholders. The allegation of the second fraud is a mere conclusory allegation not supported by the facts set forth in the complaint. The brokers were not involved in any transaction with regard to Eatontown shares, they did not make any representations concerning same, no reliance upon any broker activity is alleged, no duty of disclosure was breached, and, finally, there is no allegation that the brokers knew or took part in the preparation or dissemination of any false financial statements which Douglas Schotte is alleged to have engineered.

We agree.

In analyzing this question, it is helpful to examine common law concepts of civil liability for aiding and abetting. Under subsection (b), section 876, *Restatement of Torts*, a person is liable for harm resulting to a third person if he:

> knows that the other's conduct constitutes a breach of duty and gives substantial assistance or encouragement to the other so to conduct himself . . . .[18]

Three elements are thus required for liability: (1) that an independent wrong exist; (2) that the aider or abettor know of that wrong's existence; and (3) that substantial assistance be given in effecting that wrong.

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18. *See Ruder, supra* note 17 at 620.

The requirement of an independent wrong is no problem in this case, since plaintiffs have alleged a classic 10b-5 violation in their charge that Schotte caused the corporation to issue materially false statements upon which the plaintiffs relied in making their purchases.

The complaint is somewhat ambiguous on the question whether the brokers had knowledge of Schotte's scheme relating to the false financials. It does, however, allege that the brokerage firms knew from the volume of trading, the improper manner in which the account was handled, the instructions as to secrecy, and from personal and direct knowledge of the affairs of the bank, "that said accounts were part of a device and scheme to defraud the shareholders of the Eatontown National Bank." Some question exists as to whether this allegation is sufficient to fulfill the knowledge requirement,[19] but we need not decide this issue.

Assuming arguendo sufficient knowledge, we do not believe there is sufficient allegation of assistance by the brokers to Schotte in his misleading the shareholders. It is helpful to begin by analyzing the extent of any assistance. The omission of the substance of the brokerage transactions made the financial statements false or misleading. The brokers' assistance consisted only of handling Schotte's stock purchases and sales. The brokers could reasonably foresee that Schotte would not reveal his misconduct in the corporation's financial statements. Plaintiffs, thus, would premise liability on these facts which would equate "substantial assistance" with a business transaction (stock purchases and sales), which forseeably permits one of the parties to it (Schotte) to independently engage in illegal action as to other parties (plaintiffs).

The *Restatement* does not define with specificity the concept of "substantial assistance" but explains that

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19. *See* footnote 35 *infra*.

> If the encouragement or assistance is a substantial factor in causing the resulting tort, the one giving it is himself a tortfeasor and is responsible for the consequences of the other's act.

Restatement of Torts § 436. The *Restatement* suggests that in determining if the assistance is substantial enough to make an individual liable for the act of another, the relevant factors are: (1) the amount of assistance given by the defendant; (2) his presence or absence at the time of the tort; (3) his relation to the other person; and (4) his state of mind. In this case, it would appear that the amount of assistance given by the brokers was minor. The brokers were not present at the time of the fraud. As the district court pointed out, they were not involved in any manner with the sale of the Eatontown shares or the actual making of any misrepresentations. The "state of mind" criterion would also suggest no liability. Their assistance, although necessary for the accomplishment of Schotte's fraud, was intended to achieve another independent goal—the generation of commissions.

The concept of aiding and abetting applied in the criminal law context is also instructive. In *Nye & Nissen v. United States*, 336 U.S. 613, 619 (1949) (quoting United States v. Peoni, 100 F.2d 401, 402 (2d Cir. 1938), the Supreme Court stated:

> In order to aid and abet another to commit a crime it is necessary that a defendant "in some sort associate himself with the venture, that he participate in it as in something that he wishes to bring about, that he seek by his action to make it succeed."

This principle is well established and has been recognized in this circuit. *See, e.g., United States v. Barber*, 429 F.2d 1394 (3d Cir. 1970). It harmonizes with the criterion of "state of mind" set forth in the *Restatement* for civil liability. We have no allegation in this case that the brokers proposed to bring about the publication of the

false financials and the consequent fraud upon the stock purchasers. Applying these common law precepts substantiates our conclusion that the alleged aiding and abetting is insufficient under rule 10b-5 to render the brokers liable.

2. Rule 405 Liability

Plaintiffs also alleged broker liability for violation of New York Stock Exchange Rule 405. Rule 405 in part requires member brokers to use due diligence in learning the essential facts relative to each customer, order or account.[20] Plaintiffs alleged the brokers violated this rule in their failure to learn the actual status of ENB in the wholesale stock transactions Schotte was initiating. They further alleged that the brokers breached a duty to bank shareholders in their "total indifference" to the Rule 405 obligation, thus giving rise to a private cause of action under section 21 of the Securities Exchange Act, 15 U.S.C. § 78aa.

The district court dismissed this claim on the ground that any private cause of action which may exist under the NYSE rules extended only to actual customers of the erring broker. The court also dismissed common law allegations

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20. Rule 405 of the New York Stock Exchange provides:

Every member organization is required through a general partner, a principal executive officer or a person or persons designated under the provisions of Rule 342(b) to

(1) Use due diligence to learn the essential facts relative to every customer, every order, every cash or margin account accepted or carried by such organization and every person holding power of attorney over any account accepted or carried by such organization.

(2) Supervise diligently all accounts handled by registered representatives of the organization.

(3) Specifically approve the opening of an account prior to or promptly after the completion of any transaction for the account of or with a customer, provided, however, that in the case of branch offices, the opening of an account for a customer may be approved by the manager of such branch office but the action of such branch office manager shall within a reasonable time be approved by a general partner, or an officer who is a holder of voting stock in the organization. The member, general partner or officer approving the opening of an account shall, prior to giving his approval, be personally informed as to the essential facts relative to the customer and to the nature of the proposed account and shall indicate his approval in writing on a document which is a part of the permanent records of his office or organization.

contained in the same count for lack of a federal claim with which pendent jurisdiction could be found.[21]

This case appears to present the first opportunity this court has had to consider the issue of whether an implied federal cause of action exists for violation of stock exchange rules. Implication of such liability is a relatively recent and still evolving phenomenon. Private suits for damages for violations of the federal securities acts and regulations thereunder have been entertained widely since *J.I. Case Co. v. Borak*, 377 U.S. 426 (1964), but the development of implied liability for violation of exchange rules since its genesis two years later in Judge Friendly's dicta in *Colonial Realty Corporation v. Bache & Co.*, 358 F.2d 178 (2d Cir. 1966), has been limited.

In *Colonial Realty*, Judge Friendly found a logical statutory basis for implying private liability for violation of some exchange rules. He noted that implication of a private right of action not expressly afforded by the Exchange Act is predicated upon explicit statutory condemnation of certain conduct, a general grant of jurisdiction to enforce liabilities created by the statute, and a duty of the courts to effectuate the federal policies embodied in the Act. Courts, thus, normally consider

> the protection intended by the legislature and the ineffectiveness of existing remedies, administrative and judicial, fully to achieve that end.

Id. at 181. Securities Exchange Act § 6(b) requires all exchanges to have rules insuring proper conduct of their members in order to be registered with the SEC. This requirement forms the basis for the self-regulatory scheme established by the securities acts for national stock exchanges. Further, under § 19, the SEC retains the authority in certain areas of regulation to request modification of

21. Count XXXVII, a derivative claim alleging the same facts as alleged in count XXXVI, was dismissed as premature. See our discussion of all derivative claims *supra*.

exchange rules and promulgate superseding rules of its own.[22] In many instances, though, the SEC refrains from exercising its authority because the exchanges have already effectively established standards. Therefore, Judge Friendly reasoned:

> What emerges is that whether the courts are to imply federal civil liability for violation of exchange or dealer association rules by a member cannot be determined on the simplistic all-or-nothing basis urged by the parties; rather, the court must look to the nature of the particular rule and its place in the regulatory scheme, with the party urging the implication of a federal liability carrying a considerably heavier burden of persuasion than when the violation is of the statute or an SEC regulation. The case for implication would be strongest when the rule imposes an explicit duty unknown to the common law.

358 F.2d at 182. Using this standard, Judge Friendly went on to find no implied private cause of action under the exchange rules involved in *Colonial Realty*.

In *Buttrey v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 410 F.2d 135 (7th Cir. 1969), the Seventh Circuit considered the very NYSE rule at issue in this case. Plaintiff Buttrey was the trustee in bankruptcy for Dobich Securities Corporation, organized in 1963 by Michael Dobich. In December, 1963, defendant Merrill Lynch permitted Dobich to open a cash account in Dobich Securities' name, although

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22. The SEC reviews existing rules of the exchanges on an ongoing, informal basis. 34 SEC Ann. Rep. 63 (1968). It is empowered to order changes only in specified areas, *see* 15 U.S.C. §78s(b), and generally SEC concern over exchange rules leads to no more than negotiation with the exchanges. The SEC has used its compulsory powers to change rules rarely. *See* Note, *Private Actions as a Remedy for Violations of Stock Exchange Rules*, 83 Harv. L. Rev. 825, 827 (*citing* 10 SEC 270 (1941)) (1970); Note, *Informal Bargaining Process: An Analysis of the SEC's Regulation of the New York Stock Exchange*, 80 Yale L.J. 811 (1971).

The rationale behind Congress' establishment of this system of supervised self-regulation was a belief that the SEC would lack the resources to undertake total regulation itself. *See* SEC, Report of Special Study of Securities Markets, H.R. Doc. No. 95, 88th Cong. 1st Sess. 501 (1963).

allegedly knowing Dobich was using fraudulently converted property of Dobich Securities' customers for security transactions.

Merrill Lynch's actions allegedly violated NYSE rule 405. On the basis of the allegations, the district court stated Merrill Lynch was charged with "an almost callous disregard of Rule 405." The Seventh Circuit further characterized the actions alleged as "tantamount to fraud." Under such circumstances, the court held, an implied federal cause of action existed. Although finding, in line with *Colonial Realty*, that rule 405 was an integral part of SEC regulation, the court apparently adopted a different standard for determining whether a cause of action should be implied:

> The touchstone for determining whether or not the violation of a particular rule is actionable should properly depend upon its design "for the direct protection of investors." . . . Here one of the functions of Rule 405 is to protect the public, so that permitting a private action for its violation is entirely consistent with the purposes of the statute.

410 F.2d at 142. *See also* subsequent Seventh Circuit opinions following the same test, *Avern Trust v. Clarke*, 415 F.2d 1238, 1242 (7th Cir. 1969); *SEC v. First Securities Co. of Chicago*, 463 F.2d 981, 988 (7th Cir.), *cert. denied sub nom. McKy v. Hochfelder*, 409 U.S. 880 (1972).

The brokers in this case argue that this court should not imply federal liability for violations of stock exchange rules, as was held in the earlier Second Circuit case of *O'Neill v. Maytag*, 339 F.2d 764, 770 (2d Cir. 1964). They argue exchange rules are made "of, by and for" exchange members, rather than by a legislative body or regulatory agency balancing public interests. They further argue that any implied liability will discourage stock exchanges from vigorous self-regulation, thus damaging the legislative scheme. If we do not adopt a per se rule against implied liability, the brokers argue, nevertheless, no implied cause

of action should be found under rule 405 since it is strictly a "housekeeping" regulation solely for the protection of member firms.

Given the present posture of this case, we need not and therefore do not express any view as to whether federal causes of action should be implied for violation of stock exchange rules, or, if such causes of action should be imposed in some instances, what standard should be used to determine whether the specific alleged rule violation gives rise to the cause of action.[23] Plaintiffs in the present suit are the stockholders of the ENB. As such, they were not customers of the defendant brokers. Any claim these plaintiffs have against the brokers for failure to use due diligence to investigate the bank, as is required by Rule 405, is a derivative claim asserted on behalf of the bank as the customer.[24] Thus, even were we to accept the argument in favor of implied liability and adopt the Seventh Circuit's standard for implying liability for violation of any rule designed to protect investors, we would nonetheless find no liability in this case because the plaintiffs were not investors with whom the brokers dealt.[25]

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23. Adopting the brokers' position would lead to the anomaly that rules specifically promulgated by the SEC would provide a source for civil liability, yet those enacted by the exchanges as part of the SEC regulatory scheme would not provide any civil remedy.

Nevertheless, implication of liability should be done reluctantly for the following reasons: first, accurate evaluation of the degree to which any particular rule represents SEC policy is often difficult, if not impossible, *see* articles cited note *22 supra*; second, imposition of liability might chill the process of self-regulation by creating fear of damaging liability; and, finally, as appellees argue, exchange rules are not promulgated by a government body after careful deliberation and weighing of the variegated competing public interests. We believe Congress intended to encourage self-regulation to invoke higher standards than could feasibly be implemented by Congress or the SEC, and we should tread carefully before interfering with that scheme.

24. There may be some question, too, whether the ENB was in fact a customer, but we leave that issue, if pertinent, to the suit brought by FDIC, as receiver, against the brokers.

25. Although not expressing an opinion on the correctness of the Seventh Circuit standard, we note that it has been severely criticized on the grounds that *any* exchange rule could be considered for the protection of investors, thus implying liability to investors for *all* violations of exchange rules. *See* Note, *Civil Liability for Violation of NASD Rules: SEC v. First Securities Co.*, 121 U. Pa. L. Rev. 388, 393 (1972); Wolfson and Russo, *The Stock Exchange Member: Liability for Violation of Stock Exchange Rules*, 58 Calif. L. Rev. 1120, 1130 (1970).

Were we to accept, on the other hand, the Second Circuit's standard, we would have further reason to reach the same result. Plaintiffs have failed in this action to maintain the burden imposed of demonstrating rule 405's "place in the [federal] regulatory scheme." There is no indication in the record that the SEC participated in its formulation or was specially interested in its enactment. We find no indication that the SEC or the NYSE consider rule 405 part of the federal scheme to prevent fraudulent practices and protect investors. Indeed, to the contrary, what evidence we have been able to find in our own research points to an opposite conclusion. *See* Wolfson and Russo, *The Stock Exchange Member: Liability for Violation of Stock Exchange Rules.*, 58 *Calif. L. Rev.* 1120, 1130 n.37 (1970) (*quoting from* SEC, *Report of Special Study of Securities Markets*, pt. 1 at 316 (1963)).[26]

B. The Accountants

The complaint, also asserts liability on behalf of the plaintiff-shareholders, individually and as a class, against the accountant Burt for misstatements in ENB financial statements.[27] They specifically alleged that Burt issued to the ENB board of directors a certificate stating that except

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26. A third test for determining whether liability should be implied has been proposed in Wolfson and Russo, *supra* note 25. The authors propose liability only for (a) exchange rules promulgated after being required specifically by SEC rules and regulations, or (b) rules implicitly traceable to specific statutory provisions. Examples of (a)-type rules would be those adopted pursuant to SEC rule 11b-1 which required exchanges to adopt rules governing specialists, 17 C.F.R. §240.11b-1 (1970), or rule 11a-1 requiring certain floor trading rules, 17 C.F.R. §240.11a-1 (1970). Examples of (b)-type rules would be rules which fall within the gambit of §19(b) of the Exchange Act which permits the SEC to alter rules in certain specified areas if exchange rules are inadequate.

Under this suggested standard, it would seem no liability should be implied in the present case. No specific SEC regulation led to the promulgation of rule 405, nor does the rule seem to fall within the enumerated categories under §19(b), 15 U.S.C. §78s(b).

27. Count XXXV, based on the same allegations, was brought derivatively, was dismissed as premature by the district court, and is therefore discussed in Part I of this opinion, *supra*.

for an evaluation of loans and discounts, an examination of the statement of condition of the bank shown in its books as of April 7, 1970, presented fairly the assets and liabilities of the bank; the certificate and financial statements delivered with it were inaccurate; and Burt is therefore liable under rule 10b-5 and under state law theories of negligence.

In addition to the averments in the complaint, plaintiff Landy alleged in oral argument before the district court that as a director he received special reports from Burt certifying the bank's sound financial position, one of which was received shortly before the bank closed. According to the district court, it was uncontroverted that no other plaintiff had access to financial reports prepared by Burt; but plaintiffs asserted that ENB in issuing false and misleading statements, relied upon Burt's figures. An affidavit prepared by Leonard Skillman, a Burt partner, admits that Burt prepared financials for the bank, reporting its status as of April 30, 1968, February 25, 1969, and April 7, 1970, but says that Burt did not prepare the financial information set forth in the 1968, 1969, or 1970 annual reports.[28]

In its opinion of September 9, 1971, relying on *Fischer v. Kletz*, 266 F. Supp. 180 (S.D.N.Y. 1967), the district court denied Burt's motion to dismiss the claim against the accountants because the claim incorporated charges of false and misleading representations to the investing public resulting from gross negligence.[29] In response to Burt's motion for summary judgment and in opposition to the maintenance of a class action, the district court, on December 9, 1971, entered summary judgment against the named plaintiffs other than Landy for two independent reasons: (1) no misrepresentations were made to these parties; and (2) their depositions revealed that they did not rely upon any written report in purchasing their

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28. Burt argued at the hearing held October 12, 1971, on its motion for summary judgment, that ENB management prepared the annual report.

29. The charge of *gross* negligence does not appear in the complaint.

stock in ENB.[30] The court denied the motion as to Landy because of his alleged receipt of the accountant reports. The court also held that Landy could not maintain the suit against Burt as a class action because his claim is atypical and unique to him. The class action aspect of that decision is not challenged; the only question on appeal is whether summary judgment as to plaintiffs other than Landy was properly granted.

Plaintiffs argue on this appeal that it was foreseeable that Burt's reports "would be used as the basis for year-end and other periodic financial statements prepared by the management of Eatontown and distributed regularly to its shareholders." The record, however, does not establish that Burt knew or expected that its financial reports would be exhibited to purchasers or sellers of ENB stock. The initial agreement by which Burt was engaged by the bank, dated March 4, 1968, indicated that it was to perform a "directors examination."[31] There is nothing in the affi-

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30. The district court opinion reads:

Mrs. Gloria Landy testified it was in reliance on her personal observations at the bank, her knowledge of friends who had become depositors and her conservations [sic] with her husband, Eugene W. Landy, that she purchased the bank stock in question (See Depositions March 15, 1971, p. 68 & 74). Harry Gross, Mr. Landy's uncle by marriage, acknowledged receiving the bank's annual and semi-annual reports (Depositions, supra, at 16 & 27). However, Mr. Gross could not testify as to any purchase made in reliance upon any report. Mr. Gross also stated that he relied upon Mr. Landy in buying ENB stock (Depositions at 8 & 10). While there is testimony that Mr. Gross relied on the fact that the bank was audited and examined, there is no proof of reliance upon the alleged misleading representations. The plaintiff, Freehold Glass Company, Inc., is wholly owned by plaintiff, Harry Gross, and his family and is admittedly controlled by Mr. Gross.

31. The letter agreement, including the fees charged, indicates the limitations of the examination:

The general outline of the examination is set forth in the attached memorandum. It will be on a surprise basis and its scope will be in accordance with generally accepted auditing standards except, as you requested, we will not evaluate loans, and accordingly will include such tests of the accounting records and such other auditing procedures as we deem necessary and appropriate for the purposes of expressing our opinion on the statement of condition. It does not include a check of day-to-day transactions, as this would be economically impractical. Therefore, it will be appreciated that the examination will not necessarily disclose all irregularities, should any exist. Adequate internal control should provide your principal safeguards in this respect. Our examination will include a

davits and testimony supporting the grant of summary judgment to indicate that Burt thought its reports would be used by anyone other than the directors. The letter agreement of hire and the nature of the services to be performed indicate that Burt essentially was to make spot checks at the bank to inform the directors of the presence, if any, of irregularities. The conclusion that Burt did not expect them to be used in connection with the purchase or sale of ENB stock is reinforced because the record does not establish that Burt's figures actually were used in the bank's annual reports or its published financial statements, or exhibited to any of the plaintiffs, except Landy.[32]

None of the directors' reports was made in a manner reasonably calculated to influence the investing public. There is no proof that any were disseminated to the public or that any investor saw them except for Landy, a director and counsel for the bank. Burt delivered the reports to the bank directors for uses unconnected with stock issuance and there is no proof that anyone else saw them. We decline to extend rule 10b-5 to cover Burt's statements by finding them "in connection with the purchase or sale of any security."[32A]

Our conclusion is supported by *Wessel v. Buhler*, 437 F.2d 279 (9th Cir. 1971). In that case, the Ninth Circuit followed the test set forth in *SEC v. Texas Gulf Sulfur Co.*, 401 F.2d 833, 862 (2d Cir. 1968), that rule 10b-5 liability extends only to assertions made in a manner reasonably

(31. Continued)

general review of the bank's internal control, and we shall report any comments deemed necessary.

Our fee, inclusive of all expenses except postage, for the above service will be $1,700.00.

The reports to the directors were based on surprise inspections on April 30, 1968, February 25, 1969, and April 7, 1970, unrelated in time or purpose to the annual or public reports.

32. Under F.R.C.P. 56(a), plaintiffs could not rely on the mere allegations in their pleading but, rather, were obligated to support the allegations by affidavits or as otherwise provided in this rule with specific facts.

32A. This analysis might also preclude Landy's cause of action against the brokers, but we are not presented with that question on appeal.

calculated to influence the investing public by means of the financial media. Because the financials prepared by the accountant in *Wessel* were not publicly disseminated and no investor ever saw them, the court of appeals sustained the district court's grant of a directed verdict for the accountant-defendant.[33] It reasoned that the financials were not prepared "in connection with the purchase or sale of any security."

The Ninth Circuit also rejected the contention that liability attached because the accountant knew or should have known that his statements would be used by the corporation in preparing the prospectuses that the corporation published and on which plaintiffs relied. Judge Hufstedler noted that some of the figures from the accountant's financial statements appeared in the prospectus, along with other figures, but emphasized the absence of proof that the accountant had anything to do with the preparation of the prospectuses. As in *Wessel*, the facts in this case do not indicate that anyone other than Landy or other corporate officials saw the statements prepared by Burt and there is no evidence that Burt participated in the preparation of the published financials.

Fischer v. Kletz, 266 F. Supp. 180 (S.D.N.Y. 1967), relied on by plaintiffs although intimating that liability might attach if the accounting firm in question assists or encourages the corporation in the public use of inaccurate financials prepared by someone else, held that liability did not attach from mere knowledge that the statements issued by the corporation were inaccurate, where the accountant had not participated in any manner in preparation of the

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33. The evidence in that case showed that the accountant had been retained on three separate occasions to prepare financials for the corporation in which the plaintiffs purchased stock. On the first occasion, he was asked to prepare a financial statement in connection with an application for a surety bond. This statement was transmitted to the corporation's board. The second statement was prepared to accompany an application to the Small Business Administration for a loan. The third statement was apparently prepared for the board of directors.

financials. *Id.* at 195. We do not have in the case sub judice any allegation of substantial assistance by Burt in the preparation of financials issued by Eatontown.

To the extent that the "in connection with" requirement narrows liability to less than the foreseeable class of injured persons, rule 10b-5 liability is constricted to a smaller field than common law liability. The common law extends a defendant's liability for "fraud" to all those persons whom he should reasonably have foreseen would be injured by his misrepresentation.[34] Although common law precepts are important guideposts in defining liability under the federal securities laws, they are not determinative.[35]

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34. Rusch Factors, Inc. v. Levin, 284 F. Supp. 85, 90 (D.R.I. 1968); *See* Ultramares Corp. v. Touche, 255 N.Y. 170, 174 N.E. 441 (1931); State Street Trust Co. v. Ernst, 278 N.Y. 104, 15 N.E.2d 416 (1938); Ruder, *supra* note 17 at 614-18.

35. A possible alternative ground for upholding the district court's grant of summary judgment would be the absence of any allegation of fraudulent conduct by Burt. In Kohn v. American Metal Climax, Inc., 458 F.2d 255 (3d Cir. 1972), this circuit held that liability under rule 10b-5 requires proof of fraud in the misrepresentation. *Id.* at 269. In that case Judge Adams wrote an exhaustive and scholarly discussion of this very issue. *Id.* at 279-88 (concurring and dissenting opinion). In brief summary, he demonstrated that Congress intended that fraud be present under the rule, as was manifested by the constant usage in the congressional reports on section 10(b) of "words such as 'cunning,' 'manipulative,' 'deceptive,' 'fraudulent,' 'illicit,' 'fraud,' and 'lack of good faith,' and the absence of language indicating liability for negligent or non-negligent conduct." Judge Adams' careful examination of many of the cases that have indicated that the element of scienter is not required under rule 10b-5 shows that such cases have not provided any substantial justification for their broad language and that the element of scienter was in fact present. It is also important to heed his admonition that "the realities of the business world must be considered in formulating an appropriate rule for culpability for the operation of 10b-5." *Id.* at 287.

We do not rely, however, on the complaint's failure to allege fraud because such an allegation was apparently made at some stage in the district court proceedings. The district court, in denying both the motion for summary judgment and the motion to dismiss the complaint against Landy, indicated it was relying on an allegation of "gross negligence." On appeal, plaintiffs allege that Burt's conduct amounted to fraud because Burt pretended knowledge of the financial condition of ENB when in fact it had made an insufficient investigation to know the condition. (Appellants' Brief at 47, 50.) As we do not affirm the grant of summary judgment for Burt on the grounds the complaint did not allege fraud, we need not determine whether the allegations actually made were sufficient because the conduct averred was "tantamount to fraud." *See* Buttrey v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 410 F.2d 135, 143 (7th Cir. 1969); *Kohn, supra*, 458 F.2d at 286.

The second reason justifying the entry of summary judgment against Gloria Landy, Harry Gross, and Freehold Glass is the absence of evidence that they relied on any of Burt's reports. To an extent, the reliance requirement is similar to the "in connection with" requirement. It differs by focusing on the state of mind of the victim of the fraud rather than the perpetrator.

There is little question that reliance was an essential element of liability under common law theories of fraudulent misrepresentation. The requirement of reliance is well-established. *See, e.g., W. Prosser, Law of Torts* § 108 (1971). The *Restatement of Torts* § 531 expressly limits liability for a misrepresentation to "persons only for the pecuniary harm suffered by them *by relying* upon it in the transaction . . . in which the maker intended to influence their conduct." [Emphasis added.] A proposed revision of this section does not eliminate the reliance requirement. *Restatement of Torts* § 531 (Tent. Draft No. 10, 1964), discussed in 41 ALI Proceedings 490 (1964). *See* Ruder, *supra note* 17, at 614.

This court has indicated that reliance is necessary under rule 10b-5. *See Gottlieb v. Sandia American Corp.*, 452 F.2d 510, 516 (3d Cir. 1971), *aff'g*, 304 F. Supp. 980, 992 (E.D. Pa. 1969); *Kohn v. American Metal Climax, Inc.*, 458 F.2d 255, 269 (3d Cir. 1972). As Judge Adams, dissenting in *Kohn* on other grounds, stated:

> Although both Section 10(b) and Rule 10b-5 are silent as to reliance, Congress clearly intended that as part of a plaintiff's case he prove that he relied on the particular misleading statement of which he complains. S.Rep. 792 at 13.

458 F.2d at 288. That conclusion accords with precedents established in other circuits. *Chasins v. Smith, Barney & Co.*, 438 F.2d 1167 (2d Cir. 1970); *Rogen v. Ilkion Corp.*, 361 F.2d 260, 266-68 (1st Cir. 1966); *List v. Fashion Park, Inc.*, 340 F.2d 457, 463 (2d Cir.), *cert. denied*, 382 U.S. 811

(1965); *Kohler v. Kohler Co.*, 208 F. Supp. 808, 823 (E.D. Wis. 1962), *aff'd*, 319 F.2d 634 (7th Cir. 1963).[36]

The depositions in this case revealed that none of the plaintiffs except for Landy ever saw any of the reports prepared by Burt. They have therefore failed to support their allegation of an essential element of their cause of action under rule 10b-5. Since Burt's reports to the directors were not prepared for or disseminated to the public or the stockholders, the presumption of reliance sometimes used in other circumstances when a statement is material is inapplicable here. *See Bromberg, supra*, § 8.6(2); *Kohn v. American Metal Climax, Inc.*, 458 F.2d 255, 269 (3d Cir. 1972). Although such a presumption might apply to the annual reports issued by ENB, as already noted, Burt did not participate in their preparation.

Those portions of the order of the district court of September 9, 1971, dismissing the counts brought individually and as a class action against the defendant-brokers and dismissing the derivative counts asserted against the accountants and the brokers named as defendants in the suit instituted by the FDIC as receiver since the decision of the district court in this case will be affirmed. That portion of the order dismissing the derivative counts against the brokers not named in the FDIC suit, the Elizabeth Bank, the Reserve Bank, the NYSE, Schotte, and the FDIC as receiver will be vacated; we remand those counts to the district court for further consideration consistent with this opinion. Summary judgment in favor of Burt and against Gloria Landy, Harry Gross, and Freehold Glass will be affirmed.

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36. The only exception from the reliance requirement seems to be in cases where the requirement would defeat the purposes of the rule, such as in the "forced seller" context. *See* Vine v. Beneficial Finance Co., 374 F.2d 627, 635 (2d Cir. 1965), *cert. denied*, 389 U.S. 970 (1967).

KALODNER, *Circuit Judge*, concurring in part and dissenting in part:

I would affirm in all respects the dispositions of the District Court.

That being so, I agree with the result reached by the majority insofar as its affirmance aspects are concerned. I dissent, however, from the majority's disposition insofar as it provides that the "portion of the order dismissing the derivative counts against the brokers not named in the FDIC suit, the Elizabeth Bank, the Reserve Bank, the NYSE, Schotte, and the FDIC as receiver will be vacated," and "we remand those counts to the district court for further consideration."

The majority premises its stated vacation and remand on the circumstance that:

> "Appellants have in their brief called to our attention that the FDIC has brought suit against many of the defendants named in this action since the district court's entry of its order of dismissal, but has not named the Elizabeth Bank, the Reserve Bank, Schotte, the NYSE, and some of the brokers as parties."

The FDIC suit, referred to by the majority, was filed February 8, 1972—five months after entry of the September 9, 1971 Order here under review.

An appellate court's review of a challenged district court order is limited to the record *as it existed when the district court entered it.* To hold otherwise is to open a Pandora's Box.

As the majority has noted, we specifically held in *Jaconski v. Avisun Corporation*, 359 F.2d 931, 936 n.11 (1966) that:

> "We can consider the record only as it existed at the time the court below made the order dismissing the action."

See too, Dictograph Products Company v. Sonotone Corporation, 231 F.2d 867 (2 Cir. 1956), *petition for certiorari dismissed by stipulation,* 352 U.S. 883, 77 S.Ct. 104, 1 L.Ed.2d 82 (1956).

Rule 10(a) "Federal Rules of Appellate Procedure," 28 U.S.C.A., provides:

> "(a) COMPOSITION OF THE RECORD ON APPEAL.
>
> The original papers and exhibits filed in the district court, the transcript of proceedings, if any, and a certified copy of the docket entries prepared by the clerk of the district court *shall constitute the record on appeal in all cases.*" (emphasis supplied).

The doctrine of judicial notice, at the appellate level, may permit recognition of the filing of an action subsequent to entry of a challenged district court order, but it does not operate to make such filing a critical or dispositive factor in determining whether the district court's order was in error. The authorities cited by the majority are not to the contrary.

The majority errs in its view that "[n]either *Jaconski* nor *Dictograph Products Company,* however, involved the right of an appellate court to take judicial notice of developments in the proceeding *since* the appeal was lodged." (emphasis supplied).

The majority's error is two-fold in nature.

First, the critical date with respect to consideration of *after* developments is the date of the district court's decision, and not the date "the appeal was lodged."

Second, the majority has failed to discern that in both *Jaconski* and *Dictograph Products Company, supra,* the developments occurred *after* the district court's decision.

In *Jaconski, supra,* the district court dismissed the action for lack of jurisdictional amount on April 8, 1965. Notice of appeal was filed on May 3, 1965, and *on that day*

plaintiff filed a deposition, taken in April 1963, which purported to establish that the plaintiff's damages were in excess of the required jurisdictional amount.

In *Dictograph Products Company, supra*, the district court's judgment was entered on May 23, 1955, and plaintiff filed an appeal on May 26, 1955. *Thereafter*, plaintiff sought to introduce "new evidence" by way of a deposition which had not been presented to the district court prior to its decision.

In refusing to consider the "new evidence" the Second Circuit said:

> "On this appeal we may not consider any depositions or other evidence that were not filed in the district court *when Judge Ryan decided the motion.*" 231 F.2d at 867 (emphasis supplied).

The majority errs in citing 31 C.J.S., Evidence, § 13, at 842 (1964), in support of its holding that an appellate court may take judicial notice "of *new* developments not considered by the lower court." (emphasis supplied).

The cited section affords no nourishment to the majority's stated view, since it does not relate to developments occurring *after* the district court had rendered its decision.

The majority has failed to consider or discuss 31 C.J.S., Evidence, § 50(2), at 1026-27 (1964), which specifically states that an appellate court will *not* take judicial notice "of facts occurring *subsequently* to the judgment or order appealed from."[1] (emphasis supplied).

1.

> "It has been held that an appellate court cannot know judicially what transpired in the cause throughout its long history. *An appellate court will not, under guise of taking judicial notice of the record, take judicial cognizance of facts occurring subsequently to the judgment or order appealed from* where such facts would have been considered by the lower court if they had pre-existed the judgment and where they are not such facts as would be pertinent on a motion to dismiss the appeal . . . ."

31 C.J.S., Evidence, § 50(2), at 1026-27 (1964) (footnotes omitted) (emphasis supplied).

This, too, must be said:

There is no justification for the majority's transgression of permissible limits of judicial review in the instant case inasmuch as affirmance of the District Court's disposition would not foreclose appellants' future submission to the District Court of an appropriate application to institute derivative actions against those not named as defendants in the FDIC suit.

A True Copy:

Teste:

Clerk of the United States Court of Appeals for the Third Circuit.

Judgment of Third Circuit Court of Appeals
Entered July 30, 1973

UNITED STATES COURT OF APPEALS

FOR THE THIRD CIRCUIT

Nos. 72-1202/72-1204

Re: EUGENE W. LANDY, GLORIA LANDY, HARRY GROSS and FREEHOLD GLASS CO., INC., a corporation of the State of New Jersey, individually and on behalf of all the Shareholders of the Eatontown National Bank, in Receivership, and derivatively on behalf of the Eatontown National Bank

v.

FEDERAL DEPOSIT INSURANCE CORPORATION, Receiver for the Eatontown National Bank; DOUGLAS J. SCHOTTE; TPO INCORPORATED, a corporation of the State of New York; FILOR, BULLARD & SMYTH, a Partnership; MERRILL, LYNCH, PIERCE, FENNER & SMITH, INC., a corporation of the State of New York; BACHE & CO., INC., a corporation of the State of New York; GOODBODY & CO., a Partnership; HARRIS, UPHAM & CO., INC., a corporation of the State of New York; COWEN & CO., a Partnership; THOMSON & MCKINNON AUCHINCLOSS, INC., a corporation of the State of New York; HALLE & STIEGLITZ, a Partnership; SPINGARN, HEINE & CO., a Partnership; HEROLD, KASTOR & GEROLD INCORPORATED, a corporation of the State of New York; STERN, LAUER & CO., a Partnership; WILLIAM A. CERTILMAN, NED H. ELGART, KEITH GALLI,

BURT CUTLER, EMMETT COX, HARVEY KATZ, WALTER SIMMONS, FRANK PALUMBO, NORMAN MORRIS, FRANK DEVLIN, MAX ZYNOTOW, JOHN CLEVENGER, JAMES PERRY, ARTHUR GRANT, ALFRED BENJAMIN, JR., MAX REINE, FEDERAL RESERVE BANK OF NEW YORK, an instrumentality of the United States Government; NATIONAL STATE BANK OF ELIZABETH, a national banking association; and EDWARD R. BURT & COMPANY, certified public accountants, NEW YORK STOCK EXCHANGE, an association, and SINGER, KAPLAN, RIPPEL & BURLEY, INC., a corp. of N.Y.

EUGENE W. LANDY, GLORIA LANDY, HARRY GROSS and FREEHOLD GLASS CO., INC.,

Appellants in No. 72-1202

FEDERAL DEPOSIT INSURANCE CORPORATION, Receiver of the Eatontown National Bank,

Appellant in No. 72-1203

GLORIA LANDY, HARRY GROSS and FREEHOLD GLASS CO., INC.,

Appellants in No. 72-1204

ON APPEALS FROM THE UNITED STATES DISTRICT COURT FOR THE DISTRICT OF NEW JERSEY

Present:

KALODNER, ADAMS and ROSENN,

Circuit Judges.

JUDGMENT

This cause came on to be heard on the record from the United States District Court for the District of New Jersey and was argued by counsel.

On consideration whereof, it is now here ordered and adjudged by this Court that those portions of the order of the said District Court, filed September 9, 1971, which dismissed the counts brought individually and as a class action against the defendant-brokers and dismissed the derivative counts asserted against the accountants and the brokers named as defendants in the suit instituted by the FDIC as receiver since the decision of the district court in this case be and the same is hereby affirmed. That portion of the said order dismissing the derivative counts against the brokers not named in the FDIC suit, the Elizabeth Bank, The Reserve Bank, the NYSE, Schotte, and the FDIC as receiver be and the same is hereby vacated; and those counts are remanded to the district court for further consideration consistent with the opinion of this Court. Summary judgment in favor of Burt and against Gloria Landy, Harry Gross, and Freehold Glass, filed January 12, 1972, be and the same is hereby affirmed.

ATTEST:

M. ELIZABETH FERGUSON
Chief Deputy Clerk

COPY

July 30, 1973

Certified as a true copy and issued in lieu
of a formal mandate on September 4, 1973.

Test:

THOMAS F. QUINN
Clerk, United States Court of Appeals
for the Third Circuit

Order of Third Circuit Court of Appeals Dated August 24, 1973 Denying Plaintiffs-Appellants' Motion for Rehearing and Petition for Rehearing En Banc

UNITED STATES COURT OF APPEALS

FOR THE THIRD CIRCUIT

No. 72-1202
72-1203
72-1204

EUGENE W. LANDY, *et al.*,

Plaintiffs-Appellants,

—v.—

FEDERAL DEPOSIT INSURANCE CORPORATION, Receiver for the Eatontown National Bank, *et al.*,

Defendants-Respondents.

SUR PETITION FOR REHEARING AND PETITION FOR REHEARING EN BANC

Present:

SEITZ, *Chief Judge*, KALODNER, VAN DUSEN, ALDISERT, ADAMS, GIBBONS, ROSENN, and WEIS,
Circuit Judges.

The petition for rehearing filed by Eugene W. Landy, et al., plaintiffs-appellants, in the above entitled case hav-

ing been submitted to the judges who participated in the decision of this court and to all the other available circuit judges of the circuit in regular active service, and no judge who concurred in the decision having asked for rehearing, and a majority of the circuit judges of the circuit in regular active service not having voted for rehearing by the court in banc, the petition for rehearing is denied.

By the Court,

(sgn.) MAX ROSENN
Judge.

Dated: August 24, 1973

Statute Involved

Section 10 of the Securities Exchange Act of 1934, 15 U.S.C. §78j (1964).

Section 10 of the Securities Exchange Act of 1934 provides in pertinent part [15 U.S.C. §78j(b)]:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—
>
> • • • • •
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Regulation Involved

Rule 10b-5 of the Securities and Exchange Commission, 17 C.F.R. §240.10b-5 (1964).

Rule 10b-5, promulgated by the Securities and Exchange Commission pursuant to the authorization contained in Section 10(b) of the Securities Exchange Act of 1934, provides:

It shall be unlawful for any person directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.

Excerpts From Complaint

UNITED STATES DISTRICT COURT

FOR THE DISTRICT OF NEW JERSEY

Civil Action File No. .....

EUGENE W. LANDY, *et al.*,

Plaintiffs,

vs.

FEDERAL DEPOSIT INSURANCE CORPORATION, *et al.*,

Defendants.

FIRST COUNT

* * * * *

4. Plaintiffs fairly and adequately represent the interest of the shareholders of the Eatontown National Bank similarly situate. The Eatontown National Bank has 330 shareholders, and it is not practical for each shareholder to bring individual suits.

5. Defendant, Douglas J. Schotte, by the use of the mails and other instrumentalities of Interstate Commerce, engaged in a scheme or device to defraud the Eatontown National Bank. As part of said scheme, securities were purchased on a national stock exchange.

* * * * *

7. Defendant, Douglas J. Schotte, caused the Eatontown National Bank to issue financial statements which omitted to state the material facts necessary in order to make the statements made therein not misleading, in that said financial statements of the Eatontown National Bank failed to disclose actual or contingent liabilities of the Eatontown National Bank arising from the device and scheme to defraud.

* * * * *

9. The named plaintiffs purchased . . . securities during this period of time, relying on the published financial statements of the Eatontown National Bank . . . .

* * * * *

THIRD COUNT

* * * * *

6. On information and belief, defendant, Douglas J. Schotte, was speculating on the rise in value of said securities prior to the time he would have to pay for them. In order to cover losses in said accounts, Cashier's Checks of the Eatontown National Bank were issued without consideration.

7. On information and belief, the hereinafter-named New York Stock Exchange member firms directly or indirectly, by the use of Instrumentalities of Interstate Commerce and by the use of the mails and by the facilities of the New York Stock Exchange, employed a device, scheme and artifice to defraud the Eatontown National Bank and its shareholders; and engaged in acts and practices and courses of business which operated as a fraud or deceit upon the

Eatontown National Bank and its shareholders, said practices being in connection with the purchase and sale of approximately $200,000,000 in securities on the New York and American Stock Exchanges in the name of the Eatontown National Bank, and in connection with the purchase of shares of the Eatontown National Bank by the plaintiff shareholders.

8. The hereinafter-named New York Stock Exchange member firms, on information and belief, allowed Douglas J. Schotte to open accounts in the name of the Eatontown National Bank. Said accounts were opened illegally in violation of the National Banking Act in that they were with recourse to the Eatontown National Bank. The National Banking Act provides that a national bank may not purchase or sell securities with recourse to itself. Further, said accounts were opened in violation of the Securities Act of 1933 and the rules and regulations of the New York Stock Exchange in that said brokerage firms failed to "know their customers" as required by said statutes, rules and regulations. Further, said accounts were illegal and part of a scheme to defraud which was known, or should have been known, by said brokerage firms, in that Douglas J. Schotte, in handling the purported accounts, purported to be acting in a fiduciary capacity. The brokerage firms knew, or should have known, that he had no fiduciary powers and was not the Trust Officer of the Eatontown National Bank.

Further, all of said defendant brokerage firms knew, or should have known, from the volume of trading, of the improper extensions of credit, the improper manner in which

the account was handled, the instructions as to secrecy with which the accounts were handled and, from personal and direct knowledge of the affairs of the Eatontown National Bank, that said accounts were part of a device and scheme to defraud the shareholders of the Eatontown National Bank.

• • • • •

12. As a direct result of the manipulative and deceptive device as described above, the New York Stock Exchange member firms received commissions estimated at $3,000,000, and the individually-named account representatives received commissions of approximately $1,500,000. In order to maintain these commissions, the defendant brokerage firms and account representatives willfully or with complete and deliberate obtuseness allowed the aforesaid manipulative and deceptive device to occur.

13. On information and belief, the scheme and device to defraud occurred between January 1, 1967 and August 8, 1970. During such period of time, plaintiffs purchased shares of stock in the Eatontown National Bank and were defrauded by the deliberate concealment of the aforesaid scheme and device. They were further defrauded by the specific statements made by the above-named individual account representatives, namely, Burt Cutler, Harvey Katz, Alfred Benjamin, Jr. and Max L. Heine.

14. On information and belief, all of the other account representatives and all of the brokerage firms concealed the material facts of the massive stock market fraud being

perpetrated by the President of the Eatontown National Bank.

15. As a direct result thereof, purchasers of Eatontown National Bank stock, between January 1, 1967 and August 8, 1970, were caused substantial loss. The total loss to all shareholders of Eatontown National Bank is estimated at $4,000,000.

• • • • •